THE FEDERAL INSURANCE OFFICE'S REPORT ON MODERNIZING INSURANCE REGULATION

HEARING

BEFORE THE

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HOUSING AND INSURANCE

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE FEDERAL INSURANCE OFFICE'S REPORT ON MODERNIZING INSURANCE REGULATION

Tuesday, February 4, 2014

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND INSURANCE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Luetkemeyer, Royce, Garrett, Duffy, Hurt, Stivers, Ross; Capuano, Velazquez, Clay, Sherman, Himes, Sinema, and Beatty.

Ex officio present: Representatives Hensarling and Waters.

Also present: Representatives Ellison and Green.

Chairman NEUGEBAUER. This hearing will come to order. As previously agreed, each side will have 10 minutes for opening statements. I ask unanimous consent that Representatives Ellison and Green, who are not members of the subcommitee, be permitted to participate in the hearing. Without objection, it is so ordered.

With that, I will begin with my opening statement.

First of all, I want to thank you for coming to this important hearing examining the Federal Insurance Office (FIO) report on modernization and improving insurance regulation in the United States. The insurance sector is an extremely vital part of the U.S. economy, not only in terms of assets and asset protection, but also as a direct source of domestic jobs in this country. That is why it is imperative that Congress and the State governments work together to promote an insurance regulatory system that is efficient, dynamic, innovative, and responsive to consumer needs.

Unfortunately, the absence of uniformity in the State-based insurance regulatory system has created some inefficiencies and burdens for insurance companies and policyholders. In fact, according to the McKinsey & Company, the cost associated with these inefficiencies is approaching nearly $13 billion annually. This is unacceptable and we must, and can, do better. Accordingly, I would also like to thank Director McRaith and his staff for putting together a thoughtful report that will hopefully restart the insurance regulatory modernization debate.

Moving past arguments about the appropriate role of the FIO in these issues and their analysis of State efforts, this report goes a

long way in educating policymakers about the long-standing debates in the insurance marketplace, and will hopefully facilitate additional movement by the States towards more uniformity.

On a positive side, FIO makes some recommendations that encourage States to improve uniformity, efficiency, and consistency in their regulatory system. For example, the report identifies the need for more coordinated State market conduct exams. It addresses inefficiencies in the State product approval process and presents useful arguments against State regulation regimes.

These are examples of regulatory improvements that would be very constructive and would save costs for policyholders and the insurers. As such, the States must work diligently together to address these areas quickly or run the risk of ceding relevancy to the modernization debate.

On the other hand, the FIO report missed the mark in some areas. It glossed over many of the statutory requirements of the study, such as the feasibility of regulating certain lines of insurance at the Federal level.

And instead of wading into the more tangible issues like captive insurance regulation and corporate governance standards, the report also lights FIO's ambitions that go way beyond its statutory direction by directly advocating for the Federal regulation of mortgage insurance and, more alarmingly, suggesting that potential for binding Federal standards for insurance risk classification methods.

Further, while I appreciate the hard work of Director McRaith and his staff in this report, I am disappointed that it failed to provide any clarity on what strategic purpose the Federal Insurance Office serves.

The FIO has been in existence for over 3 years, and it is still not clear what value the office brings to the policyholders and the domestic industry. Beyond its monitoring and consulting duties, the statutory objectives, FIO included insisting the SIPI designations for insurance companies administering the Terrorist Risk Insurance Program (TRIA), coordinating Federal insurance policy overseas, and making covered agreement preemption determinations. And yet, the initial SIPI determinations were met with strong dissent from the Federal insurance experts, and there have been no formal comments on TRIA, despite its impending expiration.

Constructive coordination on international issues is largely absent and, to date, there have been no covered agreements. I want Director McRaith and his staff to succeed accordingly, and I hope 2014 will be the year that we can finally see some constructive movement on these issues and that the FIO provides some value to the insurance consumers and domestic insurers. Thank you.

With that, I recognize the ranking member of the subcommittee, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman, and I appreciate having this hearing. Director McRaith, Commissioner Leonardi, and everybody else in the audience—and I am guessing that everybody else in the audience is actually on the second panel?

[laughter]

Yes. So, that counted people in the hall.

[laughter]

This is a an important and a complicated subject that will bring out a lot of important issues that I look forward to discussing today. In many ways, I do wish that we had had the second panel first. Because I think there may be some things mentioned that I would personally like to hear Director McRaith's responses to; whatever they may be, positive, negative, agreement or not, that is not the point. To me, I look at this as a discussion, an ongoing discussion, ongoing enlightenment for those of us who sit on this side. And also, I think an opportunity for self-internal reflection of all the people who are in the audience today who are going to testify on this.

So, again, I appreciate today's hearing. I look forward to the testimony. And I thank you all for being here.

Chairman NEUGEBAUER. Now, the vice chairman of the subcommittee, Mr. Luetkemeyer, is recognized for 1½ minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. The regulation of insurance has not historically been a topic of much conversation in Congress, mainly because insurance has been, and remains, regulated by the States. That seems to be changing, and the FIO report on modernization speaks to this evolution in both productive and troubling ways.

As I have said in the past, I remain concerned that the way the United States has regulated insurance is taking a back seat to international proposals. I want to remind our panelists that the current model of regulation has, in an overwhelming majority of cases, served the American people well.

We can have efficient and consistent insurance markets without turning over the regulatory control to the Federal Government. Some modernization should, and I am confident will, happen. States should do a better job of coordinating and creating a more efficient insurance market.

But be careful what you wish for. We can see by what is going on today in practically every sector of our economy that Federal regulation can be burdensome and punitive and, therefore, counterproductive. Any modernization needs to be focused. It needs to, first and foremost, address the needs of the American people and policyholders.

Modernization efforts also need to bear in mind the considerable differences between the insurance industry and other financial services industries, and respect the unique State regulatory model that we have in place today. I look forward to a robust discussion, and thank our witnesses for joining us.

And with that, Mr. Chairman, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Himes from Connecticut is recognized for 2 minutes.

Mr. HIMES. Thank you, Mr. Chairman. And I join the chairman and the ranking member in welcoming the witnesses for what is, as the ranking member said, going to be a very, very interesting discussion with very difficult issues. So I look forward to both getting through the testimony of the panels and hearing what you have to say.

I also wanted to take a moment just to personally introduce and welcome my fellow nutmegger, Insurance Commissioner Thomas Leonardi of Connecticut. Mr. Leonardi, we are thrilled to have you

here. Those of you who don't know Commissioner Leonardi—yes, he has a lengthy career in the insurance industry; 22 years before he was Commissioner, chairman and CEO of Northington Partners. He was chosen by the Treasury Department to serve on the FIO Federal Advisory Committee on Insurance. And he also serves on the executive committee and technical committee of the International Association of Insurance Supervisors.

He has also been part of the team which, in the State of Connecticut, while the Federal healthcare.gov Web site was challenged, to say the least, helped roll out a spectacular insurance exchange which has now signed up 76,000 citizens of Connecticut for health insurance. This is in a State of 3½ million people. Many of these 76,000 people never even dreamed that they might some day have health insurance. So I thank you, Commissioner Leonardi, for your role in that.

I would also note that Commissioner Leonardi is thoughtful and outspoken. He is known for his "Jerry McGuire" moment with respect to a letter he wrote on the NAIC, a very interesting memo. He is forceful, thoughtful, and clear in his thinking. Whether you agree or disagree with him, you always know where he stands. And Commissioner, I very much look forward to hearing your testimony today.

Thank you. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from California, Mr. Royce, one of the senior members of the committee, is recognized for 2½ minutes.

Mr. ROYCE. Thank you, Mr. Chairman. This does feel like deja vu all over again, as they say. We have sat right here before. We have received testimony from Treasury on studies on how to improve insurance regulation. We have heard from current insurance Commissioners. And we have heard from former Commissioners, who testified that uniformity was right around the corner.

So in 2001—I went through my notes—2 State Commissioners testifying on behalf of the NAIC were asked by then-Chairman Oxley if uniformity and product approval was possible in 3 to 4 years.

And here is their response: "We have to meet that kind of goal. The current system is not good for consumers, and it is not good for insurance companies. If, over the next 2 to 3 years, you haven't seen significant progress, then I think there need to be questions raised about whether we can effectively, at the State level, solve the problems."

As the FIO's most recent report points out, the process for product review and approval still varies by State. And even where shortcomings have been addressed in life product approval, large markets like California, Florida, and New York have opted out. And the scope of the eligible product lines is limited.

So we have promises made, we have the promises that were broken and the hearings that have happened over and over and the studies that get written. And then, they are forgotten. So here is what I would suggest, Mr. Chairman. This committee needs to look closely at these recommendations one by one and prioritize next steps to make some of them a reality, for once. And I, for one,

would start with a covered agreement, product portability and rate reforms. But we all know that this is not a committee of one.

I challenge this committee to act on behalf of insurance consumers to let this study not be an ending point of our discussions, but a beginning. Otherwise, I am afraid we are going to be right back here again.

And finally, while I was hopeful that today's hearing would focus solely on the recently released modernization report, I would say that the timing of Commissioner Leonardi's appearance is fortuitous. I do think the Commissioner's recent letter caused quite a stir, as it criticized the NAIC's internal governance, and it promoted transparency. That was the goal of that report. And I think that is a shared goal a lot of us would like to explore with the Commissioner today.

And I thank you again, Mr. Chairman, for holding this hearing.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from California, Mr. Sherman, is recognized for 2 minutes.

Mr. SHERMAN. Looking in from the outside, the idea of State regulation of insurance looks like we would have a race to the lowest common denominator. We have seen that with corporate governance laws where, in the absence of the SEC, I am sure one of our States would basically abolish shareholder voting and install management.

But we had the best shakedown cruise one could ask for in 2008. We saw which parts of our regulatory system worked. And we saw, particularly with AIG, that those subsidiaries which were subject to State regulation remained healthy, and those entities under the same management, or overall management control which were not subject to State regulation required an enormous bailout.

When we look at credit default swaps, we are basically looking at insurance. You are insuring that a portfolio of investments won't decline in value. We disguise this by saying, well, we won't write you a check if a bad thing happens. We will just let you, at any time, swap what is your bad portfolio—or that becomes bad—for a good portfolio. I think that is absurd. What if we had a fire insurance company that didn't want to be regulated and said we don't write a check to somebody whose house burns down. We just let you swap for the non-burned-down house across the street.

That is fire insurance. That would be regulated. So I think the State system has proven itself to do well. That doesn't mean we can't do better with some action at the Federal Government. And I look forward to applying that system to disguised insurance when—instead of turning to the consumer and saying if something bad happens, we write you a check, we turn to the consumer and say, if you don't like your burned-down house, your burned-down portfolio or whatever, you can swap it for U.S. Treasury bonds or a non-burned-out house or whatever. Going forward, I look forward to building on the present system of State regulation.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the chairman of the Capital Markets Subcommittee, Mr. Garrett, is recognized for 1 minute.

Mr. GARRETT. Okay. Thank you, Mr. Chairman, for holding this hearing for a long-awaited report on how to modernize and improve the system of insurance regulation in the United States. I would also like to thank the witnesses here, and the Director, as well. After reviewing the report, I was disappointed to learn that the report only lightly touches on many important international regulatory concerns despite being the area of their greatest activity behind the scenes. Foremost, the FIO report provides little substance, analysis or any recommendations concerning existing proposals for insurance regulations.

For example, under the current ComFrame draft proposal, U.S. insurers could face international regulatory efforts to impose bank-like regulations on U.S.-based insurers. These changes could disadvantage U.S. policyholders and U.S. insurance companies competing overseas. You see, insurance companies maintain very different capital structures from banks and, as such, should not be treated in the same manner when it comes to assessing capital requirements.

Unfortunately, international insurance supervisor efforts are moving away from a coordinated approach and towards a top-down prescriptive prudential approach. And this wholesale change represents a net negative for U.S. policyholders and insurers, especially given the success of the U.S. State-based approach, which accomplishes the same type of protections using less capital and a different set of regulatory measures.

Again, I thank the chairman for this hearing, and I look forward to the testimony that follows.

Chairman NEUGEBAUER. I thank the gentleman.

I now recognize the ranking member of the full Financial Services Committee, Ms. Waters from California, for 2 minutes.

Ms. WATERS. I would like to welcome all of our witnesses to today's hearing. Today, this committee will discuss the insurance industry, a sector critical to our economy and our way of life. In fact, the United States has the largest national insurance market in the world. In 2012, premiums in two critical insurance sectors—life and health; and property and casualty—totalled more than $1.1 trillion. That accounts for approximately 7 percent of our Nation's gross domestic product.

In addition, the insurance industry plays a significant role in our job market, currently employing about 2.3 million Americans. We cannot underestimate the significance of changes to international insurance regulation. Even small changes can have a significant impact on American jobs, consumers, our economy, and global presence. With this in mind, Congress created the Federal Insurance Office to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters.

Among other responsibilities, the Federal Insurance Office is tasked with assisting the Treasury Secretary in administering the Terrorism Risk Insurance Program (TRIA). While not the subject of today's hearing, I want to reiterate the widespread support amongst Democratic members of this committee for the quick, clean, and long-term reauthorization of TRIA. I call on my Republican colleagues to consider the impact that unnecessary delays or

significant changes to the TRIA program will have on U.S. jobs, development, and our economy.

I applaud the Department of the Treasury and particularly FIO for the release of this important modernization report. It analyzes the current framework for the U.S. insurance regulatory system and provides recommendations for improvement and modernization. The report notes areas where States can work to improve uniformity, and addresses the limitations of State law. It also identifies opportunities for a Federal role in areas where States cannot make necessary improvements.

I would especially like to thank the Federal Insurance Office for the recommendations on marketplace oversight and consumer protections. While there is no question that more can be done to improve access in underserved communities, particularly minority and low-income communities, I see this report as an important first step.

I know I speak for my colleagues when I say that we are ready to work with the Federal Insurance Office, the National Association of Insurance Commissioners, and the insurance industry to ensure all families benefit from the protections and opportunities afforded by insurance.

I thank you, and I look forward to the testimony of our witnesses today. Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. I thank the gentlewoman.

And now the gentleman from Florida, Mr. Ross, is recognized for 1½ minutes.

Mr. ROSS. Thank you, Mr. Chairman. Having formerly served as chairman of the Florida House Insurance Committee, I am familiar with challenges and complexities inherent in insurance regulation. Florida's geographic location and diverse population result in a unique marketplace that varies even within the State. Over the past few decades, our Office of Insurance Regulation has both achieved successes and has acknowledged failures. In many cases, we now have set industry standards that are modeled by other States.

Florida's unique marketplace, and the developed regional experience enjoyed by our regulators, underline for me the importance of State authority in insurance regulation. Accordingly, I appreciate FIO's cautious tone. I think preserving and maintaining McCarran-Ferguson is very important. Unlike the haste of past regulations, we should be certain that any actions taken to improve and streamline regulation actually do improve and streamline regulation rather than create complex and duplicative processes.

Finally, I hope to have a productive discussion today regarding the efforts of the International Association of Insurance Supervisors to create a framework for international insurance standards. As this process moves forward, it is critical that the interests of U.S. domestic insurers are adequately represented and their specific business models are recognized. I am concerned that not properly addressing these separate business models will result in higher premiums for American families who are already struggling with the high cost of health insurance.

I look forward to today's testimony, and I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

We will now go to our panel. Each of our panel members will be recognized for 5 minutes. And without objection, your written statements will be made a part of the record.

Now, it is my pleasure to recognize Mr. Michael McRaith, Director of the Federal Insurance Office. Mr. McRaith, welcome, and thanks for coming.

STATEMENT OF MICHAEL MCRAITH, DIRECTOR, FEDERAL INSURANCE OFFICE (FIO), U.S. DEPARTMENT OF THE TREASURY

Mr. MCRAITH. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for inviting me to testify. I am Michael McRaith, Director of Treasury's Federal Insurance Office, or FIO.

Title V of the Dodd-Frank Act established FIO and directed the office to study and report on how to modernize and improve the system of insurance regulation in the United States. The report was issued in December and can be found on the Treasury Web site.

In drafting the report, our seminal premise was to evaluate the U.S. regulatory system as it is—not as it was or as one might wish it were. We learned that in 1904, President Theodore Roosevelt called for the establishment of a Federal insurance regulator.

Since that time, calls for needed reform have been framed in the same binary debate of State or Federal oversight. However, this notion of either/or, one or the other, is a relic of a bygone era. The insurance sector in the United States is vast, enormous, and diverse. A critical asset protection tool for American consumers, insurance is an essential component of the U.S. capital markets and financial system. The sector includes complex internationally active insurance groups that will continue to pursue growth in non-U.S. markets.

In the not too distant future, some flagship U.S. firms hope to generate more than half of net revenue from outside of our country. Insurance is increasingly connected with other aspects of the national and global economies, and our modernization report is grounded in this fact.

As noted in the report, State regulators perform well the essential functions of localized consumer protection, including solvency oversight of individually licensed insurance entities. State regulators have worked to enhance multi-State collaboration, and the report reflects our respect for the work of State regulators around the country.

At the same time, the inherent limits of State authority have resulted in prominent Federal supervisory roles. For example, the Federal Reserve supervises insurers at our savings and loan holding companies and those insurance firms designated by the Financial Stability Oversight Council (FSOC). The SEC reviews hundreds of indexed annuity products every year.

And, of course, the FIO statutory mandate addresses gaps in insurance oversight, including key turning with respect to an insurer under Title II of the Dodd-Frank Act, the authority to monitor all aspects of the insurance industry, including its regulation, and the

authority to represent the United States on prudential aspects of international insurance matters.

We also note that supporters of State regulation, even State regulators and NAIC staff, recognize the need for Federal involvement to deal with issues of multi-State inefficiency, as evidenced by their support for NARAB II, a Federal solution to a multi-State problem.

In addition, the Federal Government provides support for private insurance markets. To name a few you are familiar with: the Federal Crop Insurance Program; the National Flood Insurance Program; the Terrorism Risk Insurance Program; and many others. Long-standing problems with State insurance regulation need to be addressed.

Some are issues of inconsistency or unnecessary burden, like multi-State licensing or oversight of reinsurance captives. Others involve the national interest, and a direct Federal role is needed. For example, the private mortgage insurance industry is an essential feature of the national housing finance system, and warrants Federal standards and supervision. Fragmented approaches to solvency oversight do not serve homeowners, the industry, or the national economy.

Our hybrid framework, a factual reflection of the system as it is, calls for targeted Federal intervention to resolve both the challenges of inefficiency and concerns of national interest. FIO will build on our outreach efforts to consumers and industry and to our State and Federal partners as we move to effectuate the recommendations of the report. We will report publicly on State and Federal progress to address the areas identified for improvement, and we will work with Congress and this committee to determine whether, and when, the time for Federal action has arrived.

We will continue with our work to modernize and improve the U.S. system of insurance regulation at every point. Our priorities will be the best interests of the American consumers, the U.S.-based industry, and the best interests of the U.S. economy.

Thank you for your attention. I look forward to your questions.

[The prepared statement of Director McRaith can be found on page 102 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

And now, Commissioner Thomas Leonardi, from the Connecticut Insurance Department. Commissioner, welcome. Thanks for coming.

STATEMENT OF THOMAS B. LEONARDI, COMMISSIONER, CONNECTICUT INSURANCE DEPARTMENT

Mr. LEONARDI. Thank you. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, good morning. My name is Thomas Leonardi. I would like to first thank the subcommittee for providing me with the opportunity to appear before you this morning. I know that you had a pool of 56 Commissioners to choose from, and the fact that you selected me is both an honor and a privilege, which I greatly appreciate. I would also be remiss if I didn't take a brief moment to thank my boss, Dan Malloy, the Governor of the State of Connecticut, for his unfailing support for me and my department, and for appointing me as his insurance Commissioner, a job that has been the most demanding

and rewarding in my 35-year career; and lastly for his vocal commitment to our national State-based system of insurance regulation.

Hartford, Connecticut, has fondly been known as the insurance capitol of the world for over 2 centuries. We regulate the largest life insurance industry in the country and the second-largest when counting all insurance lines of business. In fact, Connecticut would rank as one of the 10 largest regulatory authorities in the world if it were a separate country. The industry represents nearly 10 percent of the State's gross domestic product, and is part of a huge financial services industry that employees more than one out of every five of our citizens.

Clearly, Governor Malloy and the citizens of the State of Connecticut have a great interest in the issues before this committee today. I also want to thank Senator Ben Nelson, the NAIC CEO, for joining me. While I am here today to offer solely my views and those of the State of Connecticut, the FIO report impacts all of my fellow State regulators. At the outset, I want to note that the Dodd-Frank Act did not task FIO to provide a broad and balanced evaluation of insurance regulation. Rather, it was specifically tasked with identifying areas where it believed improvement was needed.

Nevertheless, the FIO report, much like last summer's GAO report, and the Financial Stability Board's peer review, acknowledges that State regulators have developed an effective system of oversight that satisfies the most fundamental regulatory objectives: insurance industry solvency, and policyholder protection. We at the insurance department in Connecticut pride ourselves on meeting this objective every day. But to retain this pride, we must constantly be willing to improve and evolve to meet the next crisis or innovation.

The FIO report contains several recommendations for near term reform by the States, as well as a few suggestions for direct Federal involvement in regulation. As you might imagine, every year State regulators, legislators, and even governors receive suggestions on various insurance regulatory issues from Federal agencies, international bodies, the consumers we protect, and the industry we regulate. All suggestions on any issue deserve serious and thoughtful consideration. In this case, State regulators are still in the process of evaluating the FIO report recommendations. And we will be meeting to discuss them later this month and in the months ahead.

But I will offer a few initial observations. It is worth noting that we are already addressing many of the items identified in the report. In particular, transitions to principal-based reserving, the own-risk solvency assessment, strengthening of capital adequacy regimes, implementation of the Solvency Modernization Initiative, and discussions about improving our efforts on corporate governance and marketplace regulation are all ongoing. State regulation is not, and never has been, static.

We have made significant enhancements to our system in the last several years, and the FIO report highlights several areas where that work continues. There are recommendations, however, that give me serious pause. For example, I oppose and I believe most other State regulators oppose the idea that FIO should be al-

lowed to participate in supervisory colleges. These are designed to be meetings of prudential regulators to share confidential, company-specific information. The presence of a nonregulator, even as well-intentioned as Treasury, would threaten the objective independence not just of State regulators, but regulators at the Federal and international levels, as well as the other participants in the college.

In addition to this issue, State regulators also strongly disagree with FIO's call for the Federal oversight of mortgage insurance. A strong regulatory framework is already in place, and efforts are underway to strengthen it. The financial crisis dramatically illustrated that simply federalizing regulation is no guarantee of better results.

I appreciate FIO's efforts and all the work that went into the report. I look forward to working alongside my State regulator colleagues, as well as State legislators and governors as we consider these suggestions.

I would close by offering that the ultimate assessment of State regulation occurs not on paper, but in the outcomes we provide to policyholders and the industry. State insurance regulators oversee the broadest, deepest, and most stable insurance market in the world. And those markets weathered the worst financial crisis in generations extremely well.

And they remain stable, competitive, and a solid cornerstone of the U.S. economy. Thank you again for the opportunity to be here today.

[The prepared statement of Commissioner Leonardi can be found on page 100 of the appendix.]

Chairman NEUGEBAUER. Thank you, gentlemen. We will now go to questions for the panel. Each Member will be recognized for 5 minutes. The chairman recognizes himself for the first question. The identification of nonbanks and systemically important firms is a serious exercise that has serious implications for competitiveness in the insurance sector and the stability of our financial markets.

And as you know, recently FSOC designated Prudential Financial as a nonbank SIFI that was to be subject to an enhanced prudential standard. Interesting enough though, this was over the strong objection of all of the voting members who have any insurance expertise.

One of those members, Director John Huff, a State insurance Commissioner from Missouri recently stated, "FSOC's misguided overreliance on banking concepts is nowhere more apparent than in FSOC's basis for the designation of Prudential Financial." He went on to say that the basis for the designation was grounded in implausible, even absurd scenarios.

Commissioner Leonardi, what are your views on FSOC's designation of Prudential Financial?

Mr. LEONARDI. Congressman, let me start by saying that we in Connecticut regulate two very large subsidiaries of Prudential so we know the company quite well. And I completely agree with Roy Woodall and John Huff in their dissents.

I thought the dissents were very compelling and very well written. I have said publicly that I do not believe Prudential is sys-

temic. I would also note that the lead regulator, Commissioner Kobylowski of New Jersey, has also made this same point.

It is based on an assumption of a banking model where there could be a run on the bank and Prudential might have to sell a trillion dollars of assets the next day. And that is just—with one very rare exception—not a likely scenario on which to base a systemic designation.

Chairman NEUGEBAUER. Director McRaith, do you agree with that assessment?

Mr. MCRAITH. The FSOC process is a lengthy, detailed, highly technical process that involves many engagements with the individual firm. The voting members of the FSOC made the decision that Prudential should be designated. Those are tremendously accomplished, bright, hard-working people supported by tremendously accomplished, bright, hard-working staff.

The decision by the Council stands. Whether Roy Woodall or Director Huff disagree is fundamentally of interest to the Council. Council members did not find their views persuasive.

Chairman NEUGEBAUER. I think the concerning thing to me is that the voting members who had expertise in the insurance industry and had expertise in the regulatory structure voted against that.

And is that basically the way the structure of FSOC is now, that as we begin to move forward with some of these other insurance companies, this is going to be a trend in that the people who have expertise in that area are going to be overridden by the people who want to impose some more bank-like regulatory structure on these entities?

Mr. MCRAITH. The FSOC process is a thorough process that involves, again, many very smart people with different perspectives—

Chairman NEUGEBAUER. I know. You said that before. But I am not interested in your opinion of whether those people are smart or not. I am really interested in your opinion of, do you think this is a troubling scenario that the people who know something about—or does that trouble you; that is a yes-or-no question. Yes, it troubles you, or no, it doesn't.

Mr. MCRAITH. It doesn't trouble me because smart people can disagree.

Chairman NEUGEBAUER. Director McRaith or I guess Commissioner Leonardi, I may go back to this. As somebody who is heavily involved in regulatory development overseas, the IAIS is working on a conferring proposal. While there are over 140 countries involved in the IAIS, the United States represents a staggering 40 percent of the premium volume.

So I would imagine we are the de facto leader on these issues. Yet, the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) seems to be European-driven, a one-size-fits-all regulatory regime, which includes bank-like capital assessments. What are your opinions on the direction that we seem to be going where we seem to be trying to model our regulatory structure after what the Europeans want to do?

Mr. LEONARDI. Congressman, not surprisingly, I have been very outspoken on this issue as well. ComFrame has been out there for the entire time I have been Commissioner. It has been worked on

and a lot of effort has gone into it. It has had several drafts. One of the most recent drafts was over 150 pages. The new one, I am happy to say, is down to about 110 pages. It is going in the right direction.

But we have long expressed our concern as State regulators that it is prescriptive, it is check-the-box, it is a one-size-fits-all. In terms of the capital standards, I think that is a broader question, but let me take a moment to talk about that, because we have been opposed, whether they be bank-like or not, there is a significant point there, that a global capital standard may not be appropriate right now, but it is being forced on the IAIS by the Financial Stability Board.

And the concern is, what is the problem we are trying to solve? We don't have a global accounting standard in insurance, like we do in banks. There has never been a global accounting standard for insurance companies. We have different solvency regimes throughout the world.

And some of those are not fully implemented yet. So, my concern is that we are going to impose a global capital standard and we are going to actually do three capital standards right now. The IAIS is working on a back stock of simple capital standard that has to be done this year, followed by a higher loss absorbency capital standard, which is supposed to be in place next year for systemic companies. That will be tested by the ComFrame field testing test, and then the following year, the global capital standard.

So we are talking about implementing three capital standards on very large, internationally active insurance groups where there is no global accounting standard. And we are rushing to do them all in 3 years, in a timeframe that I personally believe is reckless.

Chairman NEUGEBAUER. Thank you. A quick follow-up here: Mr. McRaith, some people have said that this is a solution trying to find a problem. Can you quickly—and my time is already up—identify the problem that you think they are trying to address by changing these capital standards?

Mr. MCRAITH. Two issues are driving the international work: one is from the financial crisis, we learned that financial firms that are large, complex, and international are connected and have impacts on local economies; and two, the international insurance marketplace is changing dramatically so that developing economies are seeing explosive premium volume growth every year.

So our companies, U.S. companies, are pushing into new markets all the time. Those markets, those jurisdictions, want to know how is this company being supervised, can we trust its capital—that it is capitalized adequately.

Chairman NEUGEBAUER. Shouldn't they be trying to copy us rather than us copy them?

Mr. MCRAITH. Yes, so the objective through the standard-setting work is to bring together people with different views, different perspectives, and different needs to talk about approaches in their respective jurisdictions' identified best practices that are ultimately implemented—not added to, but implemented—as part of the native jurisdiction regulatory approach.

Chairman NEUGEBAUER. Thank you. I now recognize Ms. Velazquez for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Director McRaith, the FIO report implies that increasing Federal involvement will provide uniformity in insurance regulation and reduce costs for U.S. insurers and consumers. The report cites a McKinsey and Company analysis from 5 years ago, which estimated that up to $13 billion could be saved annually. Do you have a more recent estimate of the dollar amount savings, or if not, do you plan to update those numbers?

Mr. MCRAITH. We do not have a more recent number than that. We are not aware of another independent study that has been used to evaluate the cost impact. It is a continuing important conversation for us to have, whether we will do an independent study or monitor the friction costs of individual reform items that we outline in our report. I can't be sure at this point, Congresswoman.

Ms. VELAZQUEZ. Okay, according to the FIO report, there is a disparity between the qualifying collateral requirements for U.S. versus international reinsurers. FIO has recommended that Treasury and USTR pursue a covered agreement for reinsurance collateral requirements based on the NIC model collateral law. What is the timeline for pursing such an agreement and when will you be notifying Congress of your plans as required by Dodd-Frank?

Mr. MCRAITH. Thank you for that question, Congresswoman. As you well know, a covered agreement is a very serious undertaking. The authority that is vested in Treasury and the Federal Insurance Office in that context is a very serious responsibility.

We have never done it before. We are sorting through the process, the initial steps, and look forward to notifying Congress once we have our own ducks, internally, in a row. We will be in front of Congress and we look forward to working with you in that effort.

Ms. VELAZQUEZ. Do you have a timeline?

Mr. MCRAITH. We look forward to moving forward as quickly as possible.

Ms. VELAZQUEZ. Commissioner Leonardi, large-scale natural catastrophes are becoming the norm in the United States. Unfortunately, my district can attest to this firsthand. We saw millions of dollars in damage done to homes and businesses during Superstorm Sandy.

Non-flood related property and casualty claims from the storm already top $6 billion in New York. The FIO modernization report recommends that States identify and implement best practices to mitigate losses from natural disaster. Can you kindly explain to us how Connecticut and other States are working to improve insurance practices for catastrophic events like Sandy?

Mr. LEONARDI. Thank you, Congresswoman. I think it is important to point out first that as an insurance Commissioner, there is a statutory authority that I have in terms of building codes and all of those kinds of things which are impacting the issues you are talking about.

I play one very small piece in that. So if it is a suggestion by FIO that the States, as a whole, at the governor level, that is something above my pay grade, so to speak, but I do know that as your next-door neighbor, the Sandy and Irene storms have taught all of us in the northeast an important lesson.

For example, our property casualty Director, George Bradner, has been involved in the Shoreline Recovery Task Force, which is a legislative task force within Connecticut's legislature, along with the Administration, to work on these very kinds of issues.

Ms. VELAZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentlewoman, and now the gentleman from Missouri, Mr. Luetkemeyer is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Mr. McRaith, in your report you say that it is not whether insurance regulations should be State or Federal, but whether there are areas in which Federal involvement in regulation of the State database is warranted. Can you give me a definition of "warranted?" Where do you feel it is warranted for the Federal Government to step in?

Mr. MCRAITH. The report identifies a number of substantive areas where reform is appropriate if the States are unable to impose the uniformity—

Mr. LUETKEMEYER. Okay, my question is what do you believe is the criteria for the Federal Government to be warranted to intervene?

Mr. MCRAITH. I would say there is an equation where we have to balance the consumer protection of disparate approaches State-to-State and the benefits of uniformity for the industry. We balance those two and arrive at a decision of what is warranted.

Mr. LUETKEMEYER. Do you work with the NAIC at all?

Mr. MCRAITH. I speak with insurance Commissioners from around the country on a regular basis, with the officers of the NAIC—

Mr. LUETKEMEYER. It would seem to me that one of the criteria for something being warranted is if they brought you the issue and said, hey, we have a problem with this. And yet, you didn't mention that.

Mr. MCRAITH. You might remember that I was insurance Commissioner in Illinois for 6½ years before taking this job. So many of the issues, as Commissioner Leonardi mentioned in his comments, the States have been dealing with, in some cases for years, and even, in some cases, for decades.

So there is a recognized need for uniformity by the States on many of these issues and we hope to work with them to help solve the problems of the lack of uniformity.

Mr. LUETKEMEYER. Okay. In your report, you have 27 specific reforms, and basically only one of them deals with something of an international basis. All the rest of them deal with something going on in this country. In our last discussion—the last time you were here, the main impetus for your agency was to make sure that there was a relationship and a coordinated effort with regards to international insurance laws, regulations, and activities that would not be harming us in a negative way—that you could be working with them to preempt some of this stuff and yet, there is only one recommendation out of 27 here. It seems like our scope has changed. Am I missing the point here?

Mr. MCRAITH. The focus of the report is how to modernize and improve the U.S. system of insurance regulation. We were not tasked with modernizing and improving the international standard

setting activities. Our focus internationally is to represent the best interests of the United States in the standard-setting forums at the IAIS, working with our State and other Federal colleagues, and that is exactly what we are doing.

Mr. LUETKEMEYER. Mr. Leonardi, in your opening testimony, you made the comment that you are not really happy with one of the recommendations the FIO report makes mention of with regards to overset of mortgage insurance. Would you like to elaborate on that just a little bit?

Mr. LEONARDI. I would be happy to, Congressman. As I mentioned, there are strong regulations in place. The States have a lot of experienced personnel. I think if the Federal Government feels there is a role to play, in my view, it would be to look at the poor credit underwriting and lending practices that existed in the lending and banking industry that led to these problems in the first place.

The other thing I would mention is that there is a reference to permitted practices in mortgage insurance and I think it is referred to in annuities as well. And I think it is important to note that the permitted practices are being allowed in cases of really financial distress of a company, where much like in the financial crisis, the Federal Government took all sorts of extraordinary actions to help companies that would not have perhaps, made it through, get through.

So these permitted practices were an alternative to pulling the plug. You have very experienced financial regulators working with industry to try to help these companies make it through to the other side. And in most cases, they did.

Mr. LUETKEMEYER. Okay, so I guess my question would be, where is the problem that Federal oversight would be more important and beneficial than allowing the States to address this in their own way?

Mr. LEONARDI. I don't believe that it would be, Congressman.

Mr. LUETKEMEYER. My time is about up. I will yield back. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. Thank you. Now, the gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Thank you. Mr. McRaith, as you know, TRIA is expiring at the end of this year. If TRIA expires without reauthorization, it would have an adverse impact on consumers and the marketplace in general. Are you working with the Presidential working group on TRIA? Does the Administration have an official position on TRIA and will they have one before the bill of the program expires?

Mr. MCRAITH. We are working with the President's working group on financial markets to produce a report. It should be forthcoming in the near future. My expectation is sometime this month. We are certainly working hard to get that done. That is not a promise, but that is certainly our aspiration. With respect—

Mr. SHERMAN. We will put that in the record. It is a promise that it will be available by the 28th of February.

[laughter]

Mr. MCRAITH. No, no, please—I must learn to qualify my comments.

Mr. SHERMAN. I am going to move on to the next question. Mr. Leonardi, the report says that regulatory costs are about 6.8 times greater for an insurer operating in the United States than for one operating in the United Kingdom. Is moving from State to Federal regulation the solution? Is separate State regulation the cause of that 6.8? Is that 6.8 accurate?

Mr. LEONARDI. I don't know because I don't know where the numbers came from. I would be happy to look into that and I think the same applies to the McKinsey report that was referred to earlier. As someone who came out of the investment world, $13 billion gets my attention. It is a lot of money, certainly.

But I guess I would really appreciate the opportunity to see those numbers; and as to the McKenzie report, to see the assumptions and talk to the authors of the report to better understand. And I think that there may be low-hanging fruit that we could accomplish some savings without a lot of pain. And we should certainly do that if we can. But without seeing the report and seeing the assumptions underlying it, I don't know.

But there are two things—

Mr. SHERMAN. I would hope you look at that report, and get a chance to talk to those who put it together and be able to provide for this subcommittee an analysis because—and I guess one thing we are assuming is that the United Kingdom regulation is the gold standard. And it could very well be that it is 6.8 times cheaper in the United Kingdom because they don't do anything.

Mr. LEONARDI. If I could address that—I think it is important to note that, as I mentioned, we regulate the second-largest industry in the country. We have a market of 3.5 million citizens. And we do it—our costs are 79 cents for every $1,000 worth of premium. So, that is one thing that I think puts it in perspective.

I think the more important thing is, we always tend to look at expense, and we sometimes fail to look at what is the alternative. And if you look at the financial crisis—

Mr. SHERMAN. I—

Mr. LEONARDI. This is an industry where regulation has done well and where failure is an exception, not the rule. And we are still living—

Mr. SHERMAN. I—

Mr. LEONARDI. —with the after-effects of the banking—

Mr. SHERMAN. —hear your point. I do want to go on to one other question, and that is, the report talks about the "failure of the mortgage insurance industry." We had a circumstance where the bad actors in mortgages created a market in which any good actor would also lose a lot of money.

If you invested in 100 pristine perfect mortgages, or insured 100, underwritten by the angels themselves—some people lose their job, more in 2009 than at other times. There are divorces, there are deaths, there are disabilities. And given what happened to the real estate market, you are going to lose money, even if you selected these—the mortgage insurance industry has been able to raise new capital. It is paying the claims on existing liabilities. It hasn't needed a Federal bailout.

You have some broad suggestion that the Federal Government should step in with regard to mortgage insurers. What is the basis

for this insurance? And could any—look, the ship took on a little bit of water, but it faced the most enormous storm and hasn't needed a Federal bailout. Why do you think that—what is the basis for your assertion?

Mr. LEONARDI. Congressman, nearly half of the industry failed through the mortgage—through the financial crisis. The industry, in fact, was entirely displaced by the GSEs following the crisis. That there are some companies with several hundred millions of dollars now in the market is encouraging. But what we need to know is that the housing finance system that is so important to our national economy supports the private mortgage insurance industry, replaces taxpayer exposure, supports the housing market. One standard implemented uniformly across the country by one agency is the best possible result for our country.

Mr. SHERMAN. I would point out it is not just the mortgage insurance industry that was displaced by Fannie and Freddie. Basically, all lending for many years went through Fannie Mae and Freddie Mac. And I don't think we have decided that all the major banks in the country failed.

I believe my time has expired. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

And now, the gentleman from California, Mr. Royce, is recognized for 5 minutes.

Mr. ROYCE. Thank you again, Mr. Chairman.

Let's see. I would like to start with Mr. McRaith, if I could ask you a question.

As you say in the conclusion of your report, any reform proposal must also account for the threshold issue of how that reform will be achieved. And with that in mind, I was going to ask you about steps that might be taken on the following reform ideas. One was allowing auto insurance portability for military personnel. I am working on draft legislation to sort of create that portability for policies across State lines. And I was going to ask you about that. And also ask you, and maybe the Commissioner, about working on this. But that would be one.

Improving rate freedom was another issue that you raised. And I would like to get your feedback on that.

Mr. MCRAITH. Great. First of all, with respect to members of the military who are serving on military bases, it is our understanding that they are ordered to move bases every 18 to 24 months.

Mr. ROYCE. Correct.

Mr. MCRAITH. I expect you know more about this than I do. When people like that in the service of our country are following their orders, we should make it as easy for them as possible to obtain necessary personal auto insurance coverage. We will bring together, as we say in the report, leadership from the industry, from the regulatory community, and from consumer and military service member advocates to arrive at the right solution.

With respect to rate freedom or rate regulation, it is our view that competition benefits consumers. It is our view that rate freedom supports competition in many personal lines insurance markets. We want to see more of that around the country. We intend to work with regulators, and with industry to identify pilot projects. We would like to move on that as quickly as possible.

Mr. ROYCE. Thank you.

I will ask Commissioner Leonardi the same question.

After our last hearing, the NAIC took 4 months to answer my questions for the record, stating that it needed more time to make sure that the answers they gave us were accurate and complete. However, the answers we did get after 4 months were incomplete.

The NAIC provided agendas for some closed meetings. But the dozens of handouts referenced in the agendas, which would reveal the extent of those closed-door policy-making meetings were not provided. And, as you know, this is an issue.

Commissioner, I hope you will help convince the NAIC to provide the handouts for the closed policy-making meetings in question.

The NAIC's answers were inaccurate. They claimed any guidance by any NAIC committee or subcommittee or task force or working group is taken in open session, as required under the open meetings policy. That is clearly false, as people know. The agendas show that NAIC's executive committee routinely deliberates in private about policy issues. And a massive regulatory modernization plan, the issues over health insurance, producer licensing—all of that was done in private.

And just last October 25th, 4 days before its letter, NAIC abruptly closed a crucial executive committee meeting on the death masterfile for an hour of secret deliberations before returning to announce no action on it.

So, the question I would ask you is, they claim to faithfully follow the policy statement on open meetings, which promises that the NAIC will conduct its business "openly," in their words. Is it true that all NAIC committees and subcommittees conduct their business in open meetings? That would be my first question to you.

Mr. LEONARDI. Thank you, Congressman, for the question.

I want to start by saying that—and I am here as the Connecticut Commissioner. I have been asked to be here as the Connecticut Commissioner, as opposed to a representative of the NAIC today.

I obviously take these issues very seriously. Governor Malloy and I are very firm believers in transparency and openness. You may know that there was a recent revision to the statement on meetings at the NAIC. I think we have gotten very positive feedback from industry on this.

I would like to give Louisiana Commissioner and former president Jim Donelon a lot of credit for being the driving force behind pursuing this this past year.

So, I do think that those are moving in the right direction. Exactly where we are with that, I can't answer the specifics.

I do think it is important for regulators to be able to set aside some time for candid discussions that are not necessarily open. And I think it is right—reaching the correct balance.

Mr. ROYCE. Right, but the issues I am talking about are, in fact, policy issues. And so, because we are talking about the executive committee meetings being done against the policy of the NAIC, done privately, on important policy issues, these are not the types of issues that you would exempt from the open-meeting rules. And—

Chairman NEUGEBAUER. Sorry, but the time of the gentleman has expired. I appreciate his questions.

We will now recognize the gentleman from Missouri, Mr. Clay, for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman, and I thank the witnesses for being here today.

Let me start with Director McRaith.

As your report notes, insurance premiums in the life and health and property and casualty insurance sectors totalled more than $1.1 trillion in 2012, or approximately 7 percent of gross domestic product.

For several years, we have debated generally whether a State-based system can answer the regulatory demands of such a national and increasingly global insurance market. You have identified several areas in your report where if the States themselves cannot improve, a Federal role is warranted.

Can you provide a brief explanation as to how we can judge whether the States have taken matters to regulate effectively, and with sufficient uniformity?

Mr. MCRAITH. The challenges of uniformity are described in the report. The industry is vastly different today than it was 5 years ago. It will be increasingly different in 5 years time.

We will report, as I mentioned, publicly to this committee and otherwise on progress made to implement the reforms in the report. It is up to this committee and other interested parties to decide when is it appropriate for the Federal Government to be involved to impose uniformity and necessary efficiency improvements.

Mr. CLAY. As I look through the report, I don't see any reference to the topic of steering and red-lining within the insurance industry. And I would be naive to think that red-lining has been completely eliminated in the industry.

Is there a way for the FIO to take a look into this area and report back to this committee?

Mr. MCRAITH. Congressman, one of our explicit statutory responsibilities is to monitor the affordability and accessibility of insurance to traditionally underserved communities.

We take that statutory responsibility very seriously. And we are moving forward consistent with the reforms described in the report.

I should add, with respect to your state, the State department of insurance does collect information, and that is one of the few States that collects data on zip code and pricing, et cetera. And that information, I know, is publicly available.

Mr. CLAY. And do you have any national data on—I guess on different regions or metropolitan areas?

Mr. MCRAITH. At this point, we do not have any independent analysis on that subject. We would rely on external sources for information on that subject.

Mr. CLAY. Okay. Thank you.

Mr. Leonardi, as the insurance Commissioner for the State of Connecticut, you can speak very knowledgeably on the important insurance issues facing your State.

However, you, of course, don't represent other States.

Some States, like your own, conduct a large amount of insurance business, while others conduct very little.

Isn't this one of the reasons that there has been some difficulty in obtaining uniformity at the State level on many of the issues raised in the report, most of which, it seems, are not new?

Mr. LEONARDI. I guess, if I could speak to the basis premise, because the report talks an awful lot about uniformity and lack thereof, and a race to the bottom.

And the bottom line is, we have—I don't think we do a very good job of explaining what we do and how well we do it. But we have a very rigorous accreditation program at the NAIC. And right now, every State is accredited.

But when a State gets in trouble, when it has a review—and I was the vice chair of the accreditation committee for the past 2 years, so I speak with some knowledge about this. We have had States that have been brought in, much like a regulator brings a company management in when it is concerned about issues.

And we brought the States in before a group of Commissioners, and said, here are the issues, whether it is staffing, whether it is technical expertise, whether it is sloppy practices. These are the things we have found. These are the things you need to fix. Here is the timeframe within which you must fix them. And if you don't, you are going to get your—you are going to be on probation and possibly have your accreditation pulled.

So there are some very, very good floor standards, which everybody has to meet. And then there are States that do perhaps a much better job because there is a need because of the size of their industry.

But I don't think we have any States—and there is also an issue that maybe people think, maybe it is too easy because you have every State that is accredited.

It isn't easy. And I think we should celebrate the fact that we have managed to get to that level, where all the States are accredited.

Just as a brief story, back in the early 1990s when the accreditation program was formed, Connecticut, the insurance capital itself, was told, you are going to lose your accreditation. You don't have enough people.

And the then-Commissioner, I think it was Commissioner Bob Guggens went to the legislature and went into the gold dome and kicked some chairs around and said, "We need to hire people. We need to do it right away."

The legislature responded. And we have been off and running ever since.

But that is the way the process works.

Mr. CLAY. Thank you so much for your response.

Mr. Chairman, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from New Jersey, Mr. Garrett, is recognized for 5 minutes.

Mr. GARRETT. I thank the chairman.

And I thank the panel.

So what we are talking about here, as with a lot of what we do in this committee, is somewhat technical and it is somewhat hard to relate back down to the consumer.

Some of the topics we have talked about so far include Basel III capital standards and their application, and, as the chairman was talking about, a one-size-fits-all approach to that.

Now, the second panel does talk about that, if you looked at some of their testimony. I think they get into what this could mean, one-size-fit-alls applying in Basel III.

If you look at some of their testimony, this approach would create some disruption for insurance companies' balance sheets, it could affect policyholders. It could affect long-term guarantees, guarantees that carriers have made to families, to savers, to retirees.

And with that background, that is why I said at the outset that I was concerned that the report doesn't really dig into this whole area like I would hope to.

So, briefly, Director McRaith, can you tell us how you are going to convey this significant information and impact to the Fed going forward, since we really just haven't seen it either in the report or today?

Mr. MCRAITH. As you well know, the decisions of how to implement Sections 165 and 171 of Title I of the Dodd-Frank Act, those are specifically within the province of the Federal Reserve.

Mr. GARRETT. Right.

Mr. MCRAITH. Our role, one of the reasons we were established, was to create a source of insurance expertise in the Federal Government. We work with the Federal Reserve through the FSOC context. We offer our views. But it is fundamentally a decision for—

Mr. GARRETT. But I guess the point—

Mr. MCRAITH. —the Federal Reserve.

Mr. GARRETT. I get that. And I will skew on to the next question. I guess the point is is that this is a crucial area, this is an area that can directly impact my constituents back at home, if this were to be done, and we really didn't see it.

I get the point that you are supposed to be conveying this information. But we didn't see it here.

And playing off of something the gentleman from California was saying, he was talking about TRIA, but if you look into the statute, as to what you all are supposed to be doing, you have three or four different statutory obligations. Assisting with SIFI designations for insurance companies. Administering—assisting with information with regard to TRIA. As he pointed out, coordinating Federal insurance policy oversees. Making covered agreement preemptive determinations that you had talked about.

And, as also indicated, the initial SIFI designation had significant impact—significant pushback from the industry. That was already indicated.

And, of course, to come out with a report. And this report, as we know, is somewhat overdue, a couple of years overdue.

So I guess the question again is, briefly, how do you characterize what these three or four major areas that are your statutory obligations and three or four areas that really haven't been met to date on a timely basis, how do you give us a strategic purpose to actually say that we are going to get these things done in time?

And then, again, to inure to the benefit of the consumer?

Mr. MCRAITH. We have done an excellent job in fulfilling our statutory mandate, Congressman.

One reason we were created was to reflect the importance of the insurance sector in systemic risk—

Mr. GARRETT. This report was late, though, right?

Mr. MCRAITH. Yes, Congressman, the report was late.

Mr. GARRETT. By how much?

Mr. MCRAITH. The report by statute was due in January of 2012.

Mr. GARRETT. Right. So, it can't be an "excellent." "Excellent" would be an A-plus or something like that, if we would have met the deadline or came in on time.

"Excellent" would be if you hit—we wouldn't be—the gentleman from California wouldn't be asking about a TRIA determination. Excellent, it wouldn't be if these other areas, which are the statutory obligations had been met within the timeframe.

So I just beg to differ with the classification.

Let me go down a different road altogether and deal with something that you are familiar with: disparate impact.

I can go into more of this, but you are familiar with disparate impact. How will you monitor underserved groups, because I know you say that you are going to be doing that in your report?

Can you briefly talk about that, in 40 seconds or less?

Mr. MCRAITH. One thing we are committed to not doing is repeating what has been done already.

And, as you well know, Congressman, this debate about disparate impact, risk classification, insurance scores, is one that has been written about for 10, 15 years or more by many people from many different perspectives.

We intend to talk to the industry, talk to consumers, as we have, to move the conversation forward in a way that is responsible, not—

Mr. GARRETT. Very briefly, in 10 seconds, Mr. Leonardi, have the States not done an adequate job themselves in dealing with this issue?

Mr. LEONARDI. I can only speak for Connecticut, but I think we have done a very good job. And we constantly do outreach on social media and education to reach the communities that we are trying to target.

Mr. GARRETT. And do you need the Federal Government to assist you to get the job done?

Mr. LEONARDI. Absolutely not.

Mr. GARRETT. Okay.

Chairman NEUGEBAUER. I thank the gentleman.

And now, the gentlewoman from Ohio, Mrs. Beatty, is recognized for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman, and ranking members.

Let me, certainly, join my colleagues in welcoming the witnesses on this first panel today. I am from Ohio, the 3rd Congressional District, and in Columbus, Ohio, a part of my district, we are the home to many insurers of all sizes and types.

Let me shift the question to talk about terrorism risk insurance. When I reflect back on Boston and how traumatic and bad that was, although it wasn't at the level enough to warrant being certified, I wanted to pose the question, and certainly you are aware

that without congressional action, the terrorism risk insurance will expire at the end of this year.

This program creates a catastrophic government backstop for certified acts of terrorism in the United States. And many insurers have stated that they will not renew their terrorism risk policies unless the program is reauthorized.

The modernization report that was released last year does not address terrorism or TRIA, but in footnote 77, it explains that the President's working group on financial markets is studying it, and will issue a report on TRIA.

Director, do you know how long it will be before this report will be released? And has your office looked at terrorism risk insurance?

Mr. MCRAITH. Congresswoman, the expectation is that report will be released soon. By virtue of the fact that it is a President's working group, that means there are four agencies involved with the discussion. And that process is moving forward. Thoughtful people are looking at every word of a document.

We expect that to be released soon.

We, in our office, as you know, have the statutory responsibility of assisting the Secretary with administering the Terrorism Risk Insurance Program. We are very well-versed on it, very well-versed on the issues.

I think the expectation is that we will continue to be engaged on this issue. The Administration is likely to offer a policy view. Secretary Lew has previously acknowledged to the Senate and House committees his recognition of the importance of the program.

Mrs. BEATTY. Okay.

Being from Columbus, Ohio, where we have one of the largest universities in the country, the Ohio State University, which is the home of the fifth largest stadium in this country. And, as you can imagine, the cost of insurance coverage for both liability and property in the event of a terrorist attack is extremely high.

In speaking with the financial department at the university, they estimate that if they were forced to purchase the same coverage in surplus lines market, like through Lloyd's of London, that cost would be 2 to 3 times what they currently pay. How can we, as lawmakers, work to ensure that the long-term development of the robust terrorism risk insurance market—with limited government involvement—does not make it too prohibitive for them to purchase it? Do you have any thoughts on that?

Mr. MCRAITH. I don't want to offer specific policy thoughts at this time, because the Administration has not offered a view on that subject yet. However, what we see is that the terrorism risk insurance market right now functions well with the existence of the Terrorism Risk Insurance Program. The expectation is that if there are modifications or changes to that program, they should be thoughtful, with the objective of preserving an affordable and accessible terrorism risk insurance product.

Mrs. BEATTY. Okay. Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. Okay. I thank the gentlewoman. That issue of TRIA has been brought up a number of times, Mr. McRaith. And you have used the word "soon" on that report. You and I have had some conversations about report dates, and "soon"

turned out to be later, rather than sooner. So I would say that if the Administration intends to have some input into this process, sooner would be better here. Because we are already beginning to put some policy together to address that. So, you might pass that along to the working group. That is, if they have some ideas, they probably need to be sending those over sooner, rather than later.

I now recognize another Ohioan, Mr. Stivers.

Mr. STIVERS. Thank you, Mr. Chairman, I appreciate that. And thank you, Director McRaith and Commissioner Leonarid, for being here. I appreciate your work on behalf of the U.S. regulatory system of insurance. And I want to ask Director McRaith the first question. How does the FIO coordinate with the Fed and the SEC and State regulators? And by that, I don't want you to tell me that you have a great relationship with so-and-so, or you talk to so-and-so. I am curious what the process for that coordination is, if there is one? Is there a formal process for that coordination with State regulators, as well as the Fed and the SEC?

Mr. MCRAITH. Let me take those on separately. With the States, we have a variety of issues. And for domestic issues, we deal with them by speaking with NAIC officers, or going directly to the Commissioner responsible for—

Mr. STIVERS. So, no formal process, other than—

Mr. MCRAITH. We have a formal—last year we spoke—we had a regularly scheduled call, or discussion every 2 weeks. This year for international matters, because the Fed is also a participant at the IAIS now, for every meeting scheduled through the end of this calendar year, we have calls scheduled with the States and the Fed so all three parties will be on one call in advance of each meeting. And those calls are scheduled through the end of the year. The expectation is we will build on that, we will learn. Do we need to do more? Should we have meetings in person? But we will build on that.

Mr. STIVERS. I will say, it troubles me that the Fed, with no insurance regulation experience, is now representing us in the international forum. I would rather have seen another State insurance Commissioner who has expertise. That is a personal opinion. And frankly, you have a role there, but I am bothered personally that the Fed, with no experience, is sitting at the table. We don't need an empty suit at the table. I appreciate the Fed for many things, but I am not sure they add a lot of value at that table. I am not asking you to comment on that; that is a statement.

The second question I have for you is, can you talk a little bit about the IAIS and transparency? I am really concerned that there is really not a lot of open access to the meetings. They won't let observer members come into the meetings. They close a lot of information down. I just think that opaque nature makes it really hard for folks who are the dominant players in insurance in many of those jurisdictions.

Mr. MCRAITH. The precise and appropriate level of engagement with interested parties is always a question. I heard it as a Commissioner at the NAIC. I heard it in—and we hear this now at the IAIS. I think the model we want is one where the industry, the interested parties are heard. Their views are respected. They are integrated where appropriate. And then standards are developed

based on that information. Now, the process of doing that, the mechanics of that process, we need to work through. Because what we don't want to do is, we don't want to send people around the world to meetings where we repeat what we talked about months before and rehash the argument. So we need to make the meetings efficient, but we need to integrate importantly, the views of interested parties.

Mr. STIVERS. Thank you. One last question for Director McRaith, and then I hope to ask the Commissioner one question. What has the FIO done to advance the competitive position of the United States insurance industry since its inception? Have you—is that a focus for you at all to make sure that U.S. companies are competitive in foreign jurisdictions and—

Mr. MCRAITH. Absolutely, that is a priority for us. The standard-setting activities, if developed and implemented appropriately, will promote competition and fair competition in the developing economies where our companies want to grow.

Mr. STIVERS. Okay, that is a great transition to my question for the Commissioner. The United States has about 40 percent of the premium volume. The ComFrame appears to be very Eurocentric in my opinion, and I am just curious, what value does the ComFrame add to domestic policyholders, and domestic insurers? Commissioner, can you give me your opinions on those things?

Mr. LEONARDI. I would be happy to, Congressman. I think the concern I have had with ComFrame, in addition to what I said earlier, is that we have policymakers debating policy in large documents. And then we have people who are in the field, actually managing supervisory colleges. If you look at the United States—when I became Commissioner, I looked at the Financial Sector Assessment Program (FSAP) the IMF did, and it pointed out one of the few areas of weakness in the U.S. insurance regulatory system was the use of colleges and group supervision, which goes right back to the heart of the financial crisis. And when I joined the Connecticut department, we had participated in three colleges: ING; Swiss Re; and Berkshire Hathaway. We led none.

Today, we are involved in 16 colleges, and we lead six. We are the North American lead for three international companies, for a total of nine. We are working closely and collaboratively with, not only our State regulators, but regulators throughout the world. We are hosting regulators from the Swiss Financial Market Supervisory Authority (FINMA), and regulators from Taiwan and Saudi Arabia. We are coming to learn how we regulate companies. So I think what we need to do is step back and say again, what is the problem we are trying to solve with this very complex structure?

Mr. STIVERS. Thank you. I yield back the negative balance of my time.

Chairman NEUGEBAUER. Now, the gentleman from Texas, Mr. Green is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank you and the ranking member for allowing me to interlope today, and I am honored to have this opportunity to ask a few questions. I thank the witnesses for appearing. I would like to visit with you briefly, Mr. Director, on the question of arbitrage. With the different standards, and you have a multiplicity of jurisdictions, the opportunity for ar-

bitrage exists and the report addresses this. Could you elaborate for just a moment on some of your concerns associated with arbitrage?

Mr. MCRAITH. With 56 jurisdictions, the 50 States, the District of Columbia and five territories, there are different laws, regulations that are—even if adopted verbatim, are implemented differently. It is important, and our report emphasizes the importance of uniformity, not only of standards but of implementation and enforcement. An example of this is in the subject of reinsurance captives. Where while some might suggest it is an issue of the industry, our view is that it is less an issue of the industry, which is adhering to State laws, and far more an issue for the State regulators.

States are competing against one another. Ultimately the transparency, the accountability, the capital supporting those captives remains a mystery in many circumstances. We need to do better as a country.

Mr. GREEN. Thank you. And for edification purposes, for those who are not a part of the industry and don't understand all of the jargon, would you just give a brief definition of "arbitrage?" The type that you are talking about, as it relates to the industry, please?

Mr. MCRAITH. When I use the term "arbitrage" in this context, it is the pursuit of a lower level—the choice of a lower degree—of regulation or supervision as an alternative to a higher level of supervision.

Mr. GREEN. The report recommends some 20 actions that should take place. And I am curious as to whether or not you think there are some things that Congress can do to assist in this effort? If so, could you kindly give us a few things that you might have us do?

Mr. MCRAITH. Eventually—first, we want to keep you informed. We want you to be able to make determinations about, what are the issues of greatest interest to you? And when should Congress be involved in the immediate term?

Our view is, Congress should look at two issues of particular importance. One is mortgage insurance. Housing finance is an issue this committee has dealt with, and with which Congress is dealing. The mortgage insurance industry should be subject to uniform standards implemented by a Federal regulator.

Secondly, NARAB II, a bill this committee has considered, passed. The Senate has dealt with that issue. Multi-State licensing for agents and brokers is an issue in need of a national solution.

Mr. GREEN. Final question, let's talk about AIG for just a moment.

As you know, AIG nearly collapsed. And my concern, or question, really goes to, with a functioning entity oversight, could AIG have been properly regulated such that the derivatives and all of these other exotic products would not have created the economic circumstance that caused us to have to go in and provide assistance?

Mr. MCRAITH. It is hard to give a definitive answer to know whether a consolidated supervisor could have prevented all of the risk that the AIG financial products unit subjected to the entire economy, indeed to the global economy. What we do know is that we would have had a much better chance of identifying the prob-

lem earlier, stifling it much earlier, reducing or mitigating the damage much earlier than we ultimately were able to learn under the system we had in place at the time of the crisis.

Mr. GREEN. I will leave you with my speculation. My speculation is this: With a functioning entity, there would have been many who would have said that you should back off of AIG, that AIG was serving a specific role that was meaningful and that it would be inappropriate to have regulated AIG to any great extent.

I am sure there would have been many voices who would have screamed, lay off AIG. I think that this work you are doing is vitally important to the stability of our economy and possibly to the global economy.

I thank you for your service.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Virginia, Mr. Hurt, is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. I want to thank both of you gentlemen for appearing before us today on this important hearing.

I represent a rural district in Virginia. We obviously have a lot of policyholders who benefit from the products that are generated through the insurance industry.

One of the things that I hear as I travel around the district, though, especially as it relates to Dodd-Frank and access to capital on Main Streets all across our district, is that while there is often, as it relates to Dodd-Frank, a negligible, if any benefit to some of the rules that have been adopted, there is also a great cost.

And that cost, when it outweighs the benefits, results in higher costs for consumers and fewer choices.

So, I wonder about this report, and I recognize that there are several things in your report, Mr. McRaith, that you set out for direct Federal regulation, I guess my question is, is as you look at the—not getting into the possible things in the future, but the things that you all think that there really should be some direct Federal involvement in, to what extent have you all been able to analyze the sort of the costs and the benefits as it relates to having Federal involvement in mortgage insurance or any of the other items that you have laid out?

And what has guided you and what is your—what do you report?

Mr. MCRAITH. With respect to mortgage insurance, let's be clear: Nearly half of the industry failed in the financial crisis. The proposal is a uniform standard implemented at the Federal level through a Federal supervisor.

That will benefit homeowners and policyholders who have uniform capital standards implemented and enforced by a regulator at the Federal level.

In the report, we look at a couple of options to promote product availability and to reduce price. First, how do we get products approved more quickly? We talk about the interstate insurance product review compact that promotes the more efficient approval of life products. We want to see more States participate in that compact.

Second, rate regulation, as we talked about earlier, if we can restrict it in certain areas, if we can promote market competition by

reducing rate oversight, consumers—both families and individuals, and commercial consumers—will see more products available at less cost.

Mr. HURT. Okay.

And I think that every regulation that comes out of Washington is always, I am sure, very well-intended, and it is hoped, I guess, that the cost will outweigh the benefits.

What are the costs that need to be looked—that you should be aware of? What are the costs? What are the risks that are associated with this, in your mind?

And then I would like to hear from—in my time, which is diminishing, Mr. Leonardi, if he has any comments.

So if you could just quickly—

Mr. MCRAITH. I will be brief, Congressman. To be clear, in our report we do not call for the Federal Government to take over these issues.

What we call for is the States to implement uniformity in a way they have been unable to do thus far and at a point that you will be involved with when their Federal action is needed, we will have a cost-benefit analysis for you, we will be able to to determine if some Federal role is the best alternative at this—

Mr. HURT. Okay. And of course, Dodd-Frank requires that cost-benefit analysis, statutorily.

Mr. MCRAITH. Required or not, we would do that.

Mr. HURT. All right.

Mr. Leonardi, do you have any comments? A response to that?

Mr. LEONARDI. I want to go back to the arbitrage question and AIG. As I mentioned in the accreditation issue, there are very strong accreditation processes in place.

As to AIG, there is no question there were serious regulatory failures. What I think seems to be forgotten is those regulatory failures were Federal regulatory failures.

In spite of the glossing over of the Office of Thrift Supervision's role, it was the consolidated regulator. And if there was a lesson to be learned, it was that if there were supervisory colleges, if the Model Holding Company Act had been in place, if we had a group of all of the regulators at the table, including the Office of Thrift Supervision and the company, and somebody put the company on the block and said, what is the growth in this business and financial products in London, what does that mean, what are the risks associated with it, which is what colleges do. They want to understand management's view of the risks that are being addressed by the management for what the company is writing.

There would be far more confidence in a group of very smart people who are regulating pieces of the business, looking carefully at the company as a whole and that might have—I am not saying it would have, but it might have had a much better opportunity to stop that train wreck than by just depending on one consolidated regulator who has admitted in subsequent testimony that they didn't understand what they had, and that it was a much, much bigger task and a much more complicated entity than any one regulator could have controlled.

Mr. HURT. Thank you, Mr. Leonardi.

My time has expired.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Minnesota, Mr. Ellison, is recognized for 5 minutes.

Mr. ELLISON. Let me thank the chairman and also thank Ranking Member Waters for your consideration. I am very grateful.

Mr. Leonardi, I just want to ask you a quick follow-up because I didn't quite catch what you said. It sounded like you said that there was a Federal regulatory failure.

With regard to the whole financial crash of 2008 and after, I agree. But I also agree it is a multisystem failure. And with respect to insurance, and in particular AIG was mentioned, do you say that was exclusively a Federal failure?

Or do you think that the fact that we do insurance 50 different ways at least was partially at fault as well?

Mr. LEONARDI. This may surprise you, Congressman, but I do believe that. I believe that it was a failure at the Federal level. If you look at the operating companies, those companies that the State regulators were regulating, they did extremely—when in fact Superintendent Dinallo in New York had approved an extraordinary dividend of $20 billion from the operating companies that he regulated that could go up to the holding company to help some of those problems in financial products group.

So the other thing I think that needs—

Mr. ELLISON. You know what? I do appreciate—maybe we could talk more later—

Mr. LEONARDI. Sure.

Mr. ELLISON. Five minutes, you know how it is.

Mr. LEONARDI. Sure.

Mr. ELLISON. But I just wanted to get clear on how you felt about that. Let me just ask—

Mr. LEONARDI. Could I mention just one other quick thing, very quickly?

Mr. ELLISON. Okay, yes, please quick, because—

Mr. LEONARDI. I appreciate it. The Commodities Modernization Act of 2000 prohibited and prevented and preempted the States from regulating financial products, like derivatives.

Mr. ELLISON. Okay, I get your point. And I thank you for making it clear. Director McRaith, I just want to get right to the heart of a question that has been in front of this committee, and that has to do with title insurance. As I reviewed your report, I noticed that title insurance wasn't included in the report.

I want to know, did you guys look into it? Some people on our committee might claim that—or their view would be that the affiliations are solely for efficiency. And others might argue that the affiliations hide hidden referral fees that cause customers to pay more. I actually am of the second school of thought.

Did you all look into this? And what are your views on the topic?

Mr. MCRAITH. Title insurance is an important issue, an important consideration. We did not cover the entire waterfront of potential areas for reform. There are many areas we heard about and learned about that we did not include in the report. That does not mean it is not important.

Mr. ELLISON. Okay.

Mr. MCRAITH. So we—

Mr. ELLISON. You don't plan on touching on the issue?

Mr. MCRAITH. We appreciate your admonition, and it is consistent with our own understanding of the importance of that subject. And I don't want to comment too much on all of what we might do, but I think it is fair to say an issue like that is on our radar screen.

Mr. ELLISON. I will just say for the record that it would be great to know what you all think about it as soon as you come up with a position.

Mr. MCRAITH. Absolutely.

Mr. ELLISON. And then, next, I think I have a map that I would like to put up, if it is available. I have a lot of constituents, as all of us do, from diverse backgrounds. Many of my constituents are same-sex couples. And one of the issues that has come to our attention is discrimination in insurance against same-sex couples. As you see, this is addressed on page 48, box 6.

And as we know, same-sex couples face legal discrimination in 33 States, all the pink States. And then on the screen, there is a map showing 17 States where same-sex couples have equal rights. So I guess my question is, why is marital status considered in underwriting decisions? Has the insurance industry done any studies of the risk levels of same-sex couples? And what does your report recommend to eliminate the discrimination in insurance?

Mr. MCRAITH. Sir, I am not aware of whether the insurance industry has studied whether same-sex couples compare to different-sex couples with respect to marital status as a rating factor. We do know that marital status is a consideration on personal lines insurance policies, that the impact on auto insurance, for example, could be anywhere from 4 percent to 15 percent to 20 percent, depending on the individual and other characteristics. There are many variables that go in.

And recently, we have learned that at least one standardized advisory organization is proposing rates for nonmarried people above the age of 30, which is a new development. Not a significant increase or adjustment, but a meaningful indication of change.

Our report calls the question, asks the States, is it fair for same-sex couples to be lawfully married in one State, then prohibited from being married in another State, and then charged more by an insurance company for what they are prohibited from doing?

Mr. ELLISON. But would do if they could do.

Mr. MCRAITH. Would do if they could. So it is fundamentally a question of fairness, and the report calls upon the States to examine this issue and explore the fundamental fairness issue of using marital status against a same-sex couple.

Mr. ELLISON. I want to thank you gentlemen. And I yield back the time I do not have.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Wisconsin, Mr. Duffy, is recognized for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman.

Just quickly, Mr. McRaith, what is FIO's budget for 2011, 2012, and 2013?

Mr. MCRAITH. I don't know the numbers. Our budget is part of the larger departmental offices at Treasury, so I don't know the—

Mr. DUFFY. How many full-time employees do you have?

Mr. MCRAITH. We presently have 13 full-time employees.

Mr. DUFFY. Okay. So you don't know what that line item would be and how much FIO spends per year?

Mr. MCRAITH. I don't personally know that number off the top of my head, no.

Mr. DUFFY. All right. Because I am concerned, as we look at—10 reports were to be submitted, as required by Dodd-Frank, and some were never submitted to Congress. Others were a little bit late, or a lot late. The one we are talking about today was almost 2 years late. And one report was submitted on time.

I think earlier you said one of the main goals that you have is to be responsive: "We want to keep Congress informed." That was your quote. When you don't submit reports to Congress as directed by Dodd-Frank, it is pretty hard to keep us informed.

So if there is an issue with your staffing, if there is an issue with resources that is prohibiting you from providing these reports—I haven't seen a letter that you have submitted that I have been cc'd on. I don't know if you have sent a letter to the chairman.

But if we are asking for reports from FIO, we expect to get them, and get them on time. I would just leave that point out there. And maybe another point I would ask is, do you deem these reports necessary, number one? Number two, is FIO incompetent in drafting these reports and sending them to Congress? Or do you not have the staff? Which is it?

Mr. MCRAITH. The reports are important. Congress has asked for them. They are important subjects, and it is appropriate for the Treasury's Federal Insurance Office to offer them to the country, to Congress, and ultimately to the international community, to understand the views of the Federal Insurance Office on the subjects to be addressed.

Mr. DUFFY. We agree on that. Why haven't they been submitted?

Mr. MCRAITH. It is not a—excuse me?

Mr. DUFFY. Why haven't they been submitted or been submitted late?

Mr. MCRAITH. I think the important reality for us is that we submit a report to you that is of appropriate quality, of appropriate depth and insight. And while we regret that—

Mr. DUFFY. What—

Mr. MCRAITH. — the modernization report was not provided in January 2012, we are pleased with the quality and importance of the report.

Mr. DUFFY. What we expect is a quality report as asked for by Congress and on time. And that is not what you have done. So I will leave that point alone, but I think it is disrespectful to the elected body to not provide those reports as required.

I want to move to mortgage insurance. You have indicated we have had failure in the mortgage insurance space, and it is your opinion that we should have a Federal regulator in the mortgage insurance space. Is that right?

Mr. MCRAITH. That is the recommendation in our report.

Mr. DUFFY. And some of those failures came during our Great Recession. So if the Federal regulator model works so well, can you point to me other regulators, Federal regulators, that performed

well during the Great Recession, during the financial crisis, that didn't have any failures, that you can point to and say, listen, the State model doesn't work, but the Federal regulating model does work, look at this agency that did so well, in insurance or in the financial sector? Because I think they have all had issues. What makes you think that you can do it any better than everyone else, leading up to the crisis?

Mr. MCRAITH. I think the point of the recommendation is that there was failure throughout the mortgage insurance industry. We had to learn from that experience, learn from the crisis, learn, is there a better way to do that? That is why this committee and others in the House and Senate have dealt with reforming the housing finance system. As part of that, it is appropriate to have a federally-supervised private mortgage insurance industry.

Mr. DUFFY. Sure. And I guess those recommendations would be taken far more seriously if you could provide high-quality reports in a timely manner. One other issue that I want to bring up—and I guess I am concerned about the role of the Federal Government in our insurance space, if you can't tell that. And Dodd-Frank was pretty clear that you are here to monitor it.

But in Treasury's press release that came out recently, they said that you were proposing a hybrid Federal-State regulatory system. Does it say that in Dodd-Frank? Does it give that authority in Dodd-Frank? Where in that press release—where is that coming from, this hybrid model?

Mr. MCRAITH. Fundamentally, Congressman, that is what we have today. We have convened Federal agencies involved with the insurance sector, either operating a program or involved with supervision. We have over 35 agencies attending a meeting like that. So as I mentioned in my opening comments, the Federal Reserve is involved, the SEC, the Department of Labor, the Department of Agriculture, the Department of Energy, and the Department of Housing and Urban Development all have some role in the insurance sector.

So the report really doesn't call for a Federal regulator, as you appreciate. What the report says is, we need to deal with real problems that are longstanding in the U.S. system of insurance regulation, and some of those will require Federal involvement, much like, for example, NARAB II, multi-State agent licensing. How do we solve a problem of a multi-State inefficiency? Congress passes a law.

Mr. DUFFY. Thank you. And my time is up. I was hoping to ask some questions in regard to your view, Mr. Leonardi, on the expanded role of the Federal Government in our State insurance space, but my time has expired, and I will yield back to the Chair.

Chairman NEUGEBAUER. I thank the gentleman.

And now the ranking member of the full Financial Services Committee, Ms. Waters, is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

I welcome our panel here this morning. And let me just say that I recognize that Mr. McRaith came into this position almost a year after we passed Dodd-Frank, I believe. So I am sympathetic to any reports that were not released on time, as it was described by my colleague, and certainly I would not expect that you would have re-

sponsibility for that entirely. So I appreciate the work that you are doing and what it takes to do the work.

Some of my colleagues here today have talked about some of the issues that I am concerned about. Mr. Clay asked about red-lining. Representative Hurt talked about costs versus benefits. And these are some of the areas that I am certainly interested in.

I was a member of the California State Assembly for 14 years, and I worked on red-lining for almost all of those years. And, of course, having come from St. Louis, Missouri, in a low-income community, I learned a lot about insurance products and what was being pushed in the communities in my neighborhood. And I think a lot of that has been cured, but I am still concerned about what is happening in underserved communities.

Now, as I understand it, part of FIO's mission is to monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products. What have you done? And how did you do it?

Mr. MCRAITH. The statutory responsibility to monitor affordability and accessibility is very important to our office. We have compiled data from external sources and are evaluating the best ways to measure affordability and accessibility.

Our report identifies the subject of risk classification. How do companies go about pricing insurance products? The fundamental reality is that the data-mining technology available today is so much more powerful than even a few years ago. The data that any one of us could find out about any one individual is so much greater in volume than it ever used to be.

We want to have a conversation about—and do—first of all, research and report on and discuss, what are the appropriate boundaries of the use of that now expansive world of personal information that is available about any individual, not just for insurance companies, although that is our area of interest, but really throughout the world?

The data-mining technology is so much more powerful than it ever used to be. Individual products are sometimes priced with hundreds or more different factors, considerations about any one individual. We need to know, what are those factors? Do the States understand them? And then, thirdly, what are the boundaries that are appropriate on the use of all of that information?

Ms. WATERS. I am very interested in keeping up with what kind of information you are putting together and how it is going to impact the underserved communities and what we can do to make sure that there is fair access.

Let me just ask Mr. Leonardi, do you think that there has been significant improvement over the years in serving the underserved populations and minorities and our consumers in general, even in the rural communities that Mr. Hurt referred to?

Mr. LEONARDI. I can only speak as the Commissioner from Connecticut on this issue, although I did, before I was Commissioner of Connecticut, live in a very, very rural part of upstate New York. But I will say that one of the things that Director McRaith just mentioned that I agree with is, there was a time when you might have 6 to 10 risk characteristics that the companies would look at,

and now they are looking at 50 to 75. So there is a huge amount of data that they have access to, a lot of computing power to slice and dice that, and what we do is—and I think we are one of the few States that requires it, we require that they provide their guidelines so that we can see what those results will lead to.

And it may look fine on the surface, but if below the surface, if the conclusion is—of the data is that there is the potential to be red-lining—for example, some group, then we don't allow that. And we are very strict about that.

Ms. WATERS. Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. I thank the gentlewoman.

And now the gentleman from Florida, Mr. Ross, is recognized for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

Director McRaith, since 1945 the McCarran-Ferguson Act has been the foundation upon which we have had strong consumer protections because of good and sometimes bad State regulation, but I think a good market for consumers. You have alluded to—and I agree with you—that what we have in this country now is a hybrid market, and you have given some examples of that, TRIA, NFIP, and even the Affordable Care Act are involvements of the Federal Government in the regulation of insurance markets in this country.

And my concern is, is that based on your report, the FIO report, and your recommendations, if those recommendations are not met, what would you anticipate FIO to do?

Mr. MCRAITH. The first thing we are going to do is bring people together to try to solve the problem. We are doing that already. If we get to a point where the problem is not solved, then there needs to be—hopefully we can present a solution—

Mr. ROSS. And that is where my next question goes to, that solution. Do you anticipate coming back to Congress asking for regulatory authority?

Mr. MCRAITH. No, my expectation is this—the report, as you note, does not call for a Federal regulator, to the surprise—

Mr. ROSS. I appreciate that.

Mr. MCRAITH. —of some. What we say is we need to solve the problem. And rather than focus on, should we develop some structure that implements something one way or another, our objective is, solve the problem. So, for example, I cited NARAB II, something that this committee has supported. That is an example of a Federal role to impose uniformity where needed.

Mr. ROSS. So you don't anticipate seeking any regulatory authority for FIO in any time in the future or at all?

Mr. MCRAITH. What I anticipate is working hard to fulfill our current statutory mandate.

Mr. ROSS. And having been an insurance Commissioner for 6 years—in fact, I think you and I were on a panel years ago in Illinois—

Mr. MCRAITH. That is right.

Mr. ROSS. —you have been very familiar with McCarran-Ferguson. Let me ask you directly: Do you think that the McCarran-Ferguson Act as it exists today should either be upheld and left alone, modified, or repealed, and why?

Mr. MCRAITH. I don't have an opinion on the McCarran-Ferguson Act. The bottom line is, we need to move away from the State versus Federal debate, because it has stifled solutions to problems that in some cases have been around for decades.

We need as a country to provide better and more efficient regulation for consumers. In many cases, the States can do this. In some cases, it is going to require Federal help.

Mr. ROSS. And you have acknowledged, I think in your report, that consumer protections have been handled better by way of State regulation. Would you agree with that?

Mr. MCRAITH. Generally speaking, that is true. And the reason is exactly the reason you stated in your opening comments, which is, in the P&C industry in particular, there are very localized needs. Sometimes, within a State, one county is different from another.

Mr. ROSS. Exactly. Risks are not homogeneous. They are heterogeneous, essentially.

Mr. MCRAITH. That is correct.

Mr. ROSS. We see that on all types of geographic locations. Speaking in terms of our domestic insurers and their protections, we are losing market share, we are losing premium to foreign and especially European carriers. My concern is Solvency II. My concern is the backdoor of ComFrame. What guarantees or assurances can you give us that our domestic carriers can be protected, especially in light of different standards of capital requirements there may be as a result of Solvency II?

Mr. MCRAITH. Importantly, the international activity is the development of standards. It is the development of best practices for companies around—for supervisors and companies that are operating around the world. Before those standards are implemented, it will require some action by the States or the Federal Government to implement those—

Mr. ROSS. And then that is where FIO plays a role, to sort of be the spokesperson in those negotiations?

Mr. MCRAITH. Our view is, we should assert on behalf of the United States leadership in these conversations, work to develop consensus with our international counterparts, but provide the leadership that the United States justifiably should provide.

Mr. ROSS. And protect—thank you.

Mr. Leonardi, quickly, I have only 45 seconds left. Talk to me about mitigation and its importance.

Mr. LEONARDI. Mitigation, in terms of catastrophe?

Mr. ROSS. Yes.

Mr. LEONARDI. I think it is extremely important. I think that a number of the insurance companies, the large property, casualty, and reinsurance companies have recognized the need for mitigation. I think the issue is getting those provisions passed through legislatures, whether it be shutters for windstorms or fixing the shoreline, moving back from the shoreline and rebuilding, and things like that.

Mr. ROSS. Thank you. And one really quick last question, Mr. Leonardi, is there anything that you would propose to allow for the investment of private insurance for flood insurance purposes in your State? Any changes to the law today?

Mr. LEONARDI. We actually have just allowed a private insurer or a private insurer of flood insurance to sell, along with about 15 other States just in the last 3 weeks. So we would—

Mr. ROSS. It is out there. Capacity is out there, in your opinion?

Mr. LEONARDI. Yes.

Mr. ROSS. Thank you. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

Now the ranking member of the subcommittee, Mr. Capuano, is recognized for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Thank you, gentlemen, for I think a thoughtful and insightful discussion. Mr. Leonardi, I think you have advocated for a while now very effectively a very strong States' rights approach towards insurance regulation, and I respect that. And I agree with some of it. I am not sure I agree with all of it.

But I want to be sure that I understand how vehement you might be. Do you agree that some reasonable, thoughtful people might disagree with the absolute ban on any Federal involvement in overseeing any part of the insurance industry?

Mr. LEONARDI. I am not sure if I—I don't want to answer that in the negative. The answer is, yes, I obviously—as the Director has pointed out on several occasions here this morning—that the Federal Government has a role in a number of areas, flood insurance, whether that is a good or bad thing, TRIA, health insurance, and so on.

So, it is what it is. I guess what I wouldn't want is to use the fact that we have these in place for specific reasons to open the floodgates of saying, we don't need State regulation anymore. We really need to have the Federal Government come in and do things, again, fixing what is not broken, I guess is what—

Mr. CAPUANO. Right. I am not aware—there must be somebody—of anybody that I have talked to who would advocate such a wholesale, immediate transition. But there are those of us who think that some companies—never mind the individuals—may be tired of dealing with potentially 91 different regulators, 56 on the State and regional level and 35 Federal agencies. Some people might want to reduce that number and deal with only 30 or whatever the number might be, number one.

Number two is—I have been involved with financial services for a long time, mostly in the banking end of it, and I will tell you that I remember very clearly it wasn't long ago that banks had to be incorporated in a State, and it was a big brouhaha about interstate banking. Today, nobody would think twice about that, and actually some people in this room probably don't even remember that. Not many. A lot of you are at least as old as I am.

But things change. The insurance industry has clearly and unequivocally changed over the years, as you have said yourself, and become much more complicated. And by the way, as far as all those rating factors go, there is still red-lining going on, in my opinion. It may not be the old-fashioned, evil intended red-lining, but the effect is still the same. Even with all those rating factors, I know people whose auto insurance is significantly different simply by living one street away; because they live in a different ZIP Code, their

insurance is half as much, and ZIP Codes do relate to certain redlining-related issues. But that is a different discussion.

I don't have much to add to this discussion at the moment. I think the Director has thrown a lot of issues on the table, rightfully so, obviously not all of them, but a lot of them for discussion. And I think that your participation in this discussion is very important. I think it has been very thoughtful, very enlightening, and I just want to say thank you very much.

Because this is a very difficult area where I think it is inevitable that we will slowly move towards more Federal involvement, simply because of the complexity and difficulty and the internationalization of all businesses, not just insurance. So I think that is inevitable, but I also think that it should not be done quickly. It should not be done simply by throwing out a system that has worked relatively well up until this time.

And I do think that it requires the engagement and the involvement of everybody at the table, and I just want to thank the Director for your thoughtful and insightful report that raises a lot of questions. And, Mr. Leonardi, yours and NAIC's involvement with your views of the world, too, that I actually think some of them are very valuable. Some of them we may have disagreements on, but they are professional disagreements, and not esoteric ones for me.

So I just want to say thank you very much for your participation today.

Chairman NEUGEBAUER. I thank the gentleman. And I think that is all of the Members who have questions. Mr. McRaith, I want to thank you again for your support for NARAB II. We are hopeful to get that across the line. We think that is a positive step for the industry.

Mr. Leonardi, thank you, again, for your attendance. And this panel is now dismissed.

The second panel is a fairly large panel, so as one group leaves, if the other group could get in place, and we will try to get started here as quickly as we can. Again, thank you for your service.

So, we will get started. If those of you who would like to have a sidebar conversation would do that outside, we would appreciate that, so we can close the doors, and get started.

As it has been alluded to, we have a large, but very distinguished second panel. And the reason that the panel is the size it is, is that it has been the commitment of this chairman and our subcommittee to be as transparent and open and give people an opportunity to express themselves, and this is kind of new territory for the Federal Government to be in this role of FIO, a new organization. It has an impact on the industry, has an impact on consumers, and so we wanted to give the industry and other interested parties an opportunity to make their comments on this very first report.

And so, we have Mr. Anthony Cimino, vice president of insurance and trade for the Financial Services Roundtable. Welcome. He is a former Hill staffer; he served on the staff of this committee, I believe, in the past.

Mr. Paul Ehlert, president, Germania Farm Insurance, on behalf of the National Association of Mutual Insurance Companies. I might mention that Paul is from Texas. It is good to have you here.

Mr. Gary Hughes, general counsel for the American Council of Life Insurers. It is good to have you here.

Jon Jensen, president, Correll Insurance Group, on behalf of the Independent Insurance Agents & Brokers of America.

Mr. Frank Nutter, president, Reinsurance Association of America.

Mr. Robert Restrepo, president, chairman, and CEO of the State Auto Insurance Companies, on behalf of the Property Casualty Insurers Association of America.

Mr. Scott Sinder, partner, Steptoe and Johnson, on behalf of the Council of Insurance Agents & Brokers.

And Mr. Stef Zielezienski is general counsel for the American Insurance Association. I thank all of you for being here.

And with that, we will recognize Mr. Cimino for 5 minutes.

I will remind each one of you that without objection, your written statements will be made a part of the record, as well.

STATEMENT OF ANTHONY CIMINO, ACTING HEAD, GOVERNMENT AFFAIRS, THE FINANCIAL SERVICES ROUNDTABLE

Mr. CIMINO. Thank you. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testimony before you today.

My name is Anthony Cimino, and I am the acting Director of Federal affairs at the Financial Services Roundtable (FSR). My testimony today is going to focus on four key points. I will detail the need for a strong and effective Federal Insurance Office. I will identify the principles FSR believes should underpin insurance regulatory modernization. I will address certain report recommendations in greater detail. And I will urge Congress and the FIO and the NAIC to develop an action plan to improve the insurance regulatory system.

To start, FSR shares the view of many that the insurance regulatory system can be improved. To advance reforms, FIO must be a strong, effective force which will allow it to examine insurance reform on a broad national scale, interacting with State regulators on a consistent basis and objectively measuring progress.

In addition, FIO should serve as an educational resource to the Federal Government. The Federal Reserve, for instance, will oversee certain insurers that have banking operations or have been designated as SIFIs. Consequently, the Fed must now develop expertise in the insurance sector, which has vastly different risk, capital, and business models than banking institutions. FIO has a clear role in serving as that educational resource to the Fed and other Federal agencies.

Further, international forums and standard-setting efforts are influencing U.S. regulation. FIO must be a strong voice representing the U.S. interests, coordinating effectively with other stakeholders, including USTR, the Federal Reserve, and the NAIC.

Now, as to the principles of reform, FSR urges policymakers to use the following principles to underpin any modernization efforts. First, reform should establish uniform regulatory standards. Uniformity is a critical aspect of effective insurance regulation. Different standards and treatment across States increase compliance costs that ultimately drive up prices for consumers and, in some

cases, restrict product offerings. FIO should elaborate on uniform standards that will bring greater efficiency to consumers and the carriers.

Second, reforms should facilitate open and competitive markets. Regulatory policy should encourage innovation and product offerings and spur healthy price competition. Consumers benefit from competition and the ability to choose products and services that suit their needs and that are priced appropriately because of competitive market pressures.

Third, reforms should establish effective and streamlined regulations. FSR supports improved regulations. We caution that the model articulated in the report could lead to increased dual regulation, which may result in duplicative and consistent or possibly even conflicting demands. It will be important that we make sure to avoid those pitfalls.

Now, as to specific recommendations contained in the report, FSR supports many and has questions on a couple. With respect to capital standards, FIO notes in its report the different business model and risk profile of insurance companies compared to banking institutions and, as a result, the need to craft different and more appropriate tailored standards for insurers as they hold capital. FSR represents both banks and insurance companies and is uniquely positioned to understand the difference between these two models and the need to apply a more tailored capital approach to insurance companies. FSR supports efforts to do so.

Second, FSR agrees with FIO's recommendations on the improvement of the product approval process. We also urge Congress to adopt NARAB II. And we understand the need to identify and implement natural catastrophe mitigation standards.

There are, however, issues where we look forward to further information regarding FIO's plans. For instance, the report recommends States examine the impact of different rate regulation regimes and that FIO work with the States to establish a pilot program for rate regulation to maximize insurers in the marketplace.

FSR believes that an environment that increases competition ultimately drives down prices and serves consumers better. We look forward to more guidance on FIO, on how to—on how it might advance this objective.

Second, the report recommends that Treasury and USTR pursue a covered agreement on reinsurance collateral requirements to achieve national uniform treatment of reinsurers. FIO's desire to achieve this uniform treatment is welcome, but at this time, the contours of such an agreement are unknown, and FSR requests the ability to work with FIO and other stakeholders to ensure that we have our input heard.

Perhaps most importantly, we have to discuss the path forward. For the next steps, FSR urges FIO to work with Congress and the NAIC to identify this path. We see this FIO report as the first step, not an ending in and of itself or the end of the discussion, so it is going to be critical that we put in place these next steps and an action plan that moves us forward to advance insurance regulatory reform. To the extent that Congress agrees with certain recommendations or has its own reforms to advance, FSR recommends it work with FIO and NAIC to do so.

We look forward to being a part of this process, and we appreciate the opportunity to testify today. Thank you. I am happy to answer any of your questions.

[The prepared statement of Mr. Cimino can be found on page 64 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

And now Mr. Ehlert, you are recognized for 5 minutes.

STATEMENT OF PAUL EHLERT, PRESIDENT, GERMANIA INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES (NAMIC)

Mr. EHLERT. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for this opportunity to speak to you today. My name is Paul Ehlert, and I am president of the Germania Insurance Companies, a group of property and casualty companies that operate in Brenham, Texas.

Germania only operates across the State of Texas. We employ 335 people, and we protect 200,000 families and individuals, as well as a few small businesses within the State. We have been proudly serving our member policyholders and our State for 118 years.

I also serve on the board of Directors of the National Association of Mutual Insurance Companies (NAMIC). NAMIC represents more than 1,400 property and casualty insurance companies, including small farm mutuals, State and regional carriers, and large national writers. NAMIC members write half of all personal, property, and casualty lines and one-third of the commercial business in the United States.

NAMIC believes the FIO report represents a series of conversation starters for potential next steps in insurance regulatory reform, and we appreciate the subcommittee calling this hearing today. To begin, the current State-based insurance regulatory system is robust and well-positioned to meet the needs of the Nation's insurance marketplace. However, it is not perfect.

The FIO report correctly observes that regulation can be too costly and often too complex. And we wholeheartedly share the twin goals of maximizing efficiency and uniformity.

NAMIC appreciates the fact that the FIO report attempted to rise above the traditional debate of State versus Federal regulation. While it points to the increased costs of State-based insurance regulatory system, it also acknowledges the local nature of many insurance products and the cost and complexity of starting up a Federal regulatory system.

FIO concludes that the proper balance is maintenance of the State system with Federal involvement in areas where warranted, a hybrid approach. In a few targeted areas, this model could work. NAMIC supports NARAB II, for example. However, Congress should do everything in its power to avoid creating an additive system that simply layers Federal regulation on top of existing State regulation.

The report contains the implicit, but pervasive view that Federal involvement will automatically translate into increased regulatory efficiency and efficacy. The report suggests that, "if States fail to

accomplish the necessary modernizations in the near term, Congress should strongly consider direct Federal involvement."

With all due respect, it is not at all clear that Federal Government involvement will be a cure for all insurance regulatory ills. In general, the report did not go far enough in recognizing some of the limitations and potential negative consequences of increased Federal involvement.

One area which does not warrant Federal involvement, contrary to the report, is the development of binding, uniform Federal standards to restrict insurers' use of risk classification factors that are already extensively regulated in the States.

Federal regulation of insurer underwriting practices would simply substitute Congress' judgment on these matters for those of the State. NAMIC believes that FIO's focus should remain firmly on the actions and initiatives at the international level. It is our position that cooperation and coordination internationally is a positive thing, but should not result in abdication of regulatory authority to foreign jurisdictions and quasi-governmental bodies.

Too much focus on regulatory equivalence with other nations could result in significant and costly changes in the U.S. insurance regulatory system. Our system is strong and time-tested. Many of the international regulatory principles are theoretical and have never been implemented, as in the case of Solvency II. Yet, the E.U. is using these principles as a benchmark against which to compare other countries.

We believe that the FIO should be a strong advocate for the U.S. system. After all, less than 1 percent of the 2,800 U.S. property and casualty insurance companies are internationally active. We urge FIO to coordinate with State regulators to advocate for international standards that are consistent with the sound U.S. insurance regulatory approaches and that add value to our member policyholders.

At a minimum, any international standards must not impose unnecessary burdens for U.S. companies, especially the domestic foreign mutuals like my own. As we move forward, NAMIC stands ready to work with Congress on these issues. I again thank you for this opportunity to speak, and I look forward to answering your questions.

[The prepared statement of Mr. Ehlert can be found on page 70 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Hughes, you are recognized for 5 minutes.

STATEMENT OF GARY E. HUGHES, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, THE AMERICAN COUNCIL OF LIFE INSURERS (ACLI)

Mr. HUGHES. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, I appreciate the opportunity to provide you with the views of the American Council of Life Insurers on the FIO report.

Overall, we believe the report presents a fair and balanced picture of our State-based system of regulation and the various challenges it faces. I would like to focus my remarks today on two issues: first, global initiatives affecting the regulation of U.S. life

insurance companies; and second, capital standards that the Federal Reserve is now required to impose on certain life insurance groups.

The regulatory landscape for U.S. life insurers is changing dramatically. Dodd-Frank now gives the Federal Reserve a significant regulatory role with respect to those insurers that are designated as systemically important. Two of the ACLI's member companies have received that designation, and one additional company is under review for possible designation. Dodd-Frank also gives the Federal Reserve jurisdiction over another 12 of our member companies that control savings and loan institutions.

At the same time, the Financial Stability Board is directing the International Association of Insurance Supervisors to develop group capital and group supervisory standards applicable to internationally active insurance groups. We estimate that at least 18 of our member companies fall into this category.

Taken together, the initiatives of the Federal Reserve and the IAIS will directly affect companies comprising approximately 60 percent of the premiums of ACLI's overall membership. Let me put that in different terms. In the very near future, a major segment of the U.S. insurance business will have material aspects of its capital structure dictated or influenced by someone other than a State insurance regulator.

In addition, 55 of our member companies conduct significant business in the United States, but have their ultimate parent located in another country, mostly within the European Union. And the E.U. is modernizing its insurance capital standards through Solvency II.

The point here is that life insurance regulation in the United States can no longer be viewed as a purely domestic matter. And if the capital standards of the States, the Federal Reserve, the IAIS, and the E.U. are not generally consistent, the resulting competitive disparities—mainly involving the relative cost of capital—will significantly disrupt the U.S. and the global life insurance markets. That is why we believe it is imperative for all of our U.S. Representatives to work on a unified and constructive basis with the FSB and other international standard-setting bodies.

Various Federal regulatory agencies are now directly involved in matters going to the very heart of a life insurer's financial structure. And while the Federal Reserve and other agencies are making a concerted effort to enhance their understanding of our business, there is still a significant knowledge gap. We believe the FIO can be invaluable in helping fill this gap, given its mission of being the Federal repository of information on insurance and its regulation.

The office is also well-positioned to interact with the NAIC, the States, the FSB, the IAIS, and the E.U., as global capital and supervisory standards evolve. It is critical for that evolution to occur on a rational and consistent basis, and that will not happen absent strong advocacy by the FIO and the States, all working in concert and working toward common goals.

The second issue I want to address involves the holding company capital standards Dodd-Frank requires the Federal Reserve to impose on insurers that are designated as SIFIs or that own savings and loan associations.

Any holding company capital requirements made applicable to a life insurer must be compatible with the company's basic business model. Unfortunately, the scenario we face due to the Federal Reserve's interpretation of Dodd-Frank is one of applying a bank-centric regulatory regime to a life insurer.

The life insurance business is fundamentally different than the business of banking. Assets, liabilities, reserves, capital, accounting, products—each of these elements of insurance structure and regulation differs significantly from those of commercial banks.

The issue here is not whether these life insurers should be subject to holding company capital standards. They have accepted the fact they will be. The issue is making certain those standards actually work for a life insurer.

The whole purpose of these provisions of Dodd-Frank is to stabilize the U.S. financial system. Disrupting the operations of well-run insurance companies by applying ill-fitting standards is fundamentally at odds with that purpose and shouldn't occur under any circumstances.

I would like to express our appreciation to Congressman Miller and Congresswoman McCarthy for introducing H.R. 2140. This measure would enable the Federal Reserve to apply appropriate insurance-based capital standards to those life insurers under its jurisdiction. Similar legislation has been introduced in the Senate, and we look forward to working with both houses of Congress to see this important legislation enacted.

Mr. Chairman, thank you for holding this hearing, and I would be glad to answer any questions.

[The prepared statement of Mr. Hughes can be found on page 85 of the appendix.]

Mr. LUETKEMEYER [presiding]. Thank you, Mr. Hughes.

Mr. Jensen, you are next. And I would again advise all of the panelists today to be sure and pull the microphone as close to you as possible. Just take a bite out of it. That is how close it needs to be, really, because the acoustics in here are very poor, and we want to make sure everybody in the audience has a chance to hear, as well.

So, thank you very much. Mr. Jensen, you may proceed.

STATEMENT OF JON JENSEN, PRESIDENT, CORRELL INSURANCE GROUP, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA (IIABA)

Mr. JENSEN. Thank you, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. My name is Jon Jensen, and I am president of Correll Insurance Group, which has 185 employees and is headquartered in South Carolina. I am also chairman of the Government Affairs Committee for the Independent Agents & Brokers of America, also known as the "Big I."

The Federal Insurance Office was charged with a massive assignment, and the Big I commends Director McRaith and his staff for producing a comprehensive and largely balanced assessment of the insurance regulatory system. The report has generated well-deserved attention and analysis and identifies and recommends several areas of reform.

The recommendations offered in the report suggest that the insurance regulatory system is functioning at a high level and does not require significant overhaul and restructuring. The Big I agrees strongly with this assessment and several of the recommendations in the report, including FIO's call for the adoption of the NARAB II agent licensing legislation.

While many of the recommendations are worthy of discussion and review, I would like today to highlight four of the broader themes the Big I found in the report. First, the report reminds us that insurance regulations, as with any system of regulatory oversight, are imperfect and can always be enhanced. However, State insurance regulation has a strong and successful record and has performed particularly well when compared to other financial sectors, especially in recent years. The report reminds us of the success, but also that the system must continue to evolve and improve.

Second, the Big I believes that the report observes that the establishment of a full-blown Federal regulatory framework is not a prudent or viable option. While some expected this recommendation from FIO, the report instead indicates, "the proper formulation for the debate at present is not whether insurance regulation should be State or Federal, but whether there are areas in which Federal involvement in regulation under the State-based system is warranted."

Third, the recommendations in the report are noticeably modest. They reaffirm the relative health of State insurance regulation and indicate that sweeping and wholesale changes are unnecessary and unwarranted. The report recognizes that State officials have identified and are working to remedy certain flaws within the existing system, and many of FIO's suggestions encourage States to continue their pursuit of existing efforts and note that FIO intends to simply monitor their progress.

Fourth, the report recommends the use of targeted Federal intervention should be limited to those instances where demonstrated deficiencies exist and where States are unable as a result of practical hurdles or collective action issues to resolve the challenges themselves.

The report states, "In all events, Federal involvement should be targeted to areas in which that involvement would solve problems resulting from the legal and practical limitations of regulations by States, such as the need for uniformity or the need for a Federal voice in U.S. interactions with international authorities."

One specific example of such targeted Federal intervention that the report recommends is the NARAB II legislation to reform agent licensing. Specifically, FIO discusses the need for agent licensing reform at length, and we greatly acknowledge and appreciate the emphasis given to this issue in this report.

We are equally appreciative of the leadership of the chairman, and of Representative David Scott, who have been steadfast supporters of this legislation over the past several years. In fact, last June the NARAB II legislation passed the full House by a vote of 397–6, and we are also pleased that the measure was approved by the full Senate last week.

The NARAB II proposal is a textbook example of how targeted action at the Federal level can enhance and improve State regula-

tion without Federal regulation. The Big I is pleased that the NARAB II continues its progress through the legislative process, and the agent and broker community is optimistic that this much-anticipated measure will be enacted into law in the near future.

I thank the subcommittee for this opportunity to testify today, and I look forward to a continued discussion regarding the issues addressed in my testimony.

[The prepared statement of Mr. Jensen can be found on page 93 of the appendix.]

Mr. LUETKEMEYER. Thank you, Mr. Jensen.

Mr. Nutter, you are next. Please proceed.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA (RAA)

Mr. NUTTER. Mr. Chairman, and members of the subcommittee, I am Franklin Nutter, president of the Reinsurance Association of America (RAA). The RAA is the national trade association representing reinsurance companies doing business in the United States. RAA members consist of both U.S.- and non-U.S.-based companies with an interest in the regulatory environment in which they operate, including solvency in financial oversight, as well as market access.

The RAA supported the provision in the Dodd-Frank Act that authorizes the Federal Insurance Office, working with the U.S. Trade Representative to enter into covered agreements. This gives those governmental entities the authority—indeed, we believe the mandate—to pursue bilateral or multilateral agreements regarding prudential measures with respect to the business of insurance or reinsurance between the United States and one or more foreign governments. These covered agreements will provide uniform regulatory criteria for transactions between U.S. and non-U.S. insurers and reinsurance.

Insurance is widely regarded as facilitating economic activity, and reinsurance provides insurers with capital support, diversification of risk, and risk transfer for extreme loss events. Covered agreements will facilitate the provision of global capital and risk-taking capacity and, therefore will benefit economic activity in the United States and in other countries.

We envision these covered agreements to provide the regulatory framework for U.S. reinsurers in foreign countries and non-U.S.-reinsurers in the United States. We do not see this as a new layer of regulation, but rather as a federally-authorized tool that would be applied in the context of their State regulatory system.

We are pleased to see the Federal Insurance Office report endorse the pursuit of covered agreements. The FIO report defines its interest in the context of financial security provided by unauthorized reinsurers based on the NAIC's recently revised model law and credit for reinsurance. The RAA supports the recent NAIC model law revisions and has worked vigorously to see them enacted in various States.

It is clear, however, that it will take many years for these changes to be adopted by all the States. The NAIC model law process as applied to this model law also assumes the States individually, based on an NAIC-approved list of qualified jurisdictions,

will make a determination of the equivalence of a foreign country's reinsurance regulation.

The RAA believes covered agreements, based on Federal statutory and constitutional authority between the United States and countries or governmental entities representing major reinsurance trading partners, provide the preferred approach for addressing the basis of regulatory equivalence and appropriate regulatory security.

It is clear that the statutory authority in Dodd-Frank does not limit covered agreements to matters related to collateral for unauthorized reinsurance. There are a host of Federal prudential issues that could be addressed in a covered agreement as the basis upon which companies from one jurisdiction do business in the other jurisdiction.

We recognize the use of this authority beyond collateral may concern some. However, the statute requires a process of review by four congressional committees, including this one, the likely involvement of the States with FIO and the USTR in negotiating any such agreement, and, finally, implementation within the State regulatory system, not a new Federal system. We think these protections should allay those concerns.

We believe the European Union under its reinsurance directive and Solvency II when implemented has the authority to enter into covered agreements. In addition, regulatory and trade officials in countries that host major insurance and reinsurance trading partners, including the U.K., Bermuda, Germany, France, Italy, Australia, Japan, and Switzerland have all expressed interest in resolving the issue of cross-border reinsurance relationships.

The United States is a major attractive market for the global reinsurance industry. The United States is also the home jurisdiction for several major reinsurers that operate on a global basis and provide financial security for worldwide insurance markets. A covered agreement should and could be tailored to be of mutual value to both of these interests.

We encourage the committee to insist that USTR and Treasury move forward on negotiation of one or more covered agreements. This committee originated the idea and was right to do so, and we look forward to working with the committee, FIO, and USTR to implement this valuable tool. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Nutter can be found on page 109 of the appendix.]

Mr. LUETKEMEYER. The next witness is Mr. Restrepo. I think Mrs. Beatty wants to provide the introduction, so, Mrs. Beatty, you are up.

Mrs. BEATTY. Thank you so much, Mr. Chairman and Mr. Ranking Member. It is certainly an honor for me to not only serve on the House Financial Services Committee, but it is not often that you get a constituent who has done so much in the area of insurance in your district, so it gives me great pleasure to not only introduce, but to welcome Mr. Robert Restrepo to the committee, and I look forward to hearing his testimony today.

Mr. LUETKEMEYER. Thank you. Mr. Restrepo, you may proceed.

STATEMENT OF ROBERT RESTREPO, PRESIDENT, CHAIRMAN, AND CHIEF EXECUTIVE OFFICER, STATE AUTO INSURANCE COMPANIES, ON BEHALF OF THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA (PCI)

Mr. RESTREPO. Thank you, Mr. Chairman and Mr. Ranking Member, for inviting PCI to testify today. My name is Bob Restrepo, and I am president, chairman, and CEO of the State Auto Insurance Companies and chairman of PCI. For nearly a century, State Auto has provided a wide range of protection for consumers and businesses through independent agents and brokers, and we employ 2,500 people across the country.

PCI has more than 1,000 member companies that account for 39 percent of the premium for the United States home, auto, and business insurance marketplace. My written testimony discusses the current regulatory system and how it could be improved. There are four key points, though, that I would like to highlight for the committee today.

The U.S. property and casualty insurance market is the largest and most diverse in the world. Our market weathered the financial crisis of 2008 better than most federally-regulated sectors, and is financially sound, highly competitive, and comprehensively regulated, with a strong consumer focus.

State regulators are able to respond quickly to local needs and realities. Property casualty financial strength and capitalization is at a record high, and our regulation and marketplace is constantly evolving to meet consumer needs and underserved markets.

PCI welcomes a better Federal understanding of the challenges our marketplace faces, which were described in the FIO report. PCI has analyzed each recommendation based on our mission. And we asked ourselves, does it promote and protect the viability of a competitive private insurance marketplace for the benefit of consumers and insurers?

Several FIO recommendations could potentially improve our current insurance regulatory system. Among these are its calls for more free-market competition in pricing, better coordinated market conduct exams, streamlining of commercial lines regulation, better disaster risk mitigation, congressional enactment of NARAB II, and more standardization of surplus lines rules.

Recommendations that could harm our market and consumers include a federalization of insurance rating factors and pressure to adopt bank-like global standards that have not been proven to benefit domestic home, auto, and business insurance consumers or our marketplace.

While the FIO report is an insightful compilation of current regulatory challenges, there are two particular areas where FIO's leadership would be helpful and consistent with the Dodd-Frank Act statutory priorities. First, FIO should play a greater role in establishing meaningful ongoing coordination among all Federal and State governmental and private voices in international discussions.

Second, we need FIO to be a strong advocate for transparency, due process, and cost-benefit analysis in all regulatory forums on behalf of our marketplace and our consumers.

In conclusion, I would like to suggest that Congress can consider this report in two different ways. If the goal is primarily to encour-

age the States towards greater efficiency, consistency, and coordination, domestically and internationally, then it should serve a useful purpose, considering each recommendation separately.

To the extent the report becomes a foundation for piecemeal hybrid, Federal-State regulation policy, then the policymakers need to be careful of just adding additional layers of supervision, keeping in mind the oath that two of my brothers took as doctors of medicine, "First, do no harm."

Thank you for the opportunity.

[The prepared statement of Mr. Restrepo can be found on page 114 of the appendix.]

Mr. LUETKEMEYER. Thank you, Mr. Restrepo.

And Mr. Sinder, you are next. You may proceed. Thank you, and welcome.

STATEMENT OF SCOTT SINDER, GENERAL COUNSEL, THE COUNCIL OF INSURANCE AGENTS & BROKERS (THE COUNCIL)

Mr. SINDER. Thank you, Mr. Chairman, Ranking Member Capuano, and members of the subcommittee. My name is Scott Sinder. I am a partner at the law firm of Steptoe and Johnson, where I chair the government affairs and public policy group, and I also serve as the general counsel for the Council of Insurance Agents & Brokers, on whose behalf I testify today.

The Council has about 240 members. They sell or place about 85 percent of all commercial business insurance in the United States, as well as billions of dollars of benefits work, and they also do business abroad. Forty of their members are located abroad, but most of their members do work internationally.

Today, the business of insurance is no longer a local business. It is a Statewide business. It is a national business. It is an international business. And that is true on at least three levels. It is true for our members who do work in all those areas. It is true for their clients who have exposures on all those levels. And it is also true from the regulatory perspective as they are subject to regulations at all those levels, both here and abroad.

Chairman Neugebauer began the hearing by asking what role FIO is to play and was sort of critical of the report for not clarifying that. I think you have heard a lot of answers to that, but I would answer it directly by saying that I think that the role of FIO falls into three buckets. There is the leadership on the international level on the policymaking side. There is the oversight of the State system in an effort to spur them to modernize and rationalize and harmonize the regulatory structures. And there is the repository of insurance expertise at the Federal level, which we have never had before, and I think is a welcome addition. And in some respects, the report does touch on all three of those areas.

As the report says, it is not so much the question of Federal versus State authority, but what are the best ways to rationalize and harmonize regulatory oversight of insurance. Mr. Royce commented that he went back and looked at his notes from 2001, and he commented on the pace of reform. There is a quote on page 11 of the report, of which I am particularly fond, that is a quote from the very first meeting of the NAIC in 1871, where they said that

the entire purpose of the NAIC is to create a system of uniform national insurance regulations.

I would argue that absent Federal oversight and prodding, there has been very little progress on that. Even the accreditation project and system that Commissioner Leonardi discussed was the outgrowth of the Dingell oversight proceedings in the early 1990s, when there was an insolvency crisis in the industry that was also cited in the report. And so, we think that FIO can play a very important role in doing that prodding.

On the international level, we welcome this point of entry and effort to try to coalesce around a single voice for the United States. We think it is a welcome addition. There is something that is not mentioned in the report that we are very focused on as an industry at the moment, and that is the Foreign Account Tax Compliance Act (FATCA). I think that is a place where the international requirements of the office meet its informational role. FACTA is an act that the IRS is intending to apply to the property and casualty industry. It is an act that is designed to spur reporting of cash value accounts that are maintained by U.S. citizens living abroad.

By applying it to us, you have a tremendous additional compliance cost with, I would argue, no regulatory bang for your buck. And so we are working—and we hope that you will work with us—to try to get that limited so FACTA does not apply to the reporting of property and casualty insurance premiums, which really are completely unrelated to the regime.

On the domestic side, we would note three things. First of all, many of you commented on TRIA, which is only mentioned in the footnote in the report. Ranking Member Waters said that she is looking for a quick, clean, and long-term resolution to the TRIA issues and that time is of the essence. We couldn't agree more.

From a policyholder perspective, what is really important is that we have the capacity in the market to cover terrorism risks. We think that TRIA offers that. Already in the market, you are seeing renewals that have riders which say that the terrorism portion of the coverage will expire on December 31st, absent extension of the program.

With respect to surplus lines reform, Dodd-Frank included the NRRA provisions. We agree with what Director McRaith and FIO said in the report about the pace of reform there. We, too, are disappointed that some States are not complying with the same rules as the rest of the States, and we would argue that a single State taxation regime that most of the States have adopted is the right way to go. It is the most efficient. And it is the best, I think, both from a regulatory perspective, as well as the regulatee perspective.

Finally, several folks have mentioned NARAB II. It did pass the Senate last week. We thank Chairman Neugebauer and Representative Scott for their leadership in the House on this. This is a bill that has passed the House 3 times. It would, I think, both raise the standard of regulation of insurance licensure for multi-State licensing and make it much more efficient. Rather than going through 56 relatively low bars to get a license, there would just be 2, your home State regulation and the admission to NARAB, which would require a higher level of standards to be satisfied in order to be licensed.

NARAB II has been included in the flood bill in the Senate. We urge you to include it as you consider the flood bill when it moves back through the House. I am happy to answer any questions, and I thank you again for the opportunity to testify.

[The prepared statement of Mr. Sinder can be found on page 118 of the appendix.]

Mr. LUETKEMEYER. Thank you, Mr. Sinder.

And finally, Mr. Zielezienski, you may proceed.

STATEMENT OF J. STEPHEN "STEF" ZIELEZIENSKI, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, THE AMERICAN INSURANCE ASSOCIATION (AIA)

Mr. ZIELEZIENSKI. Thank you, Mr. Chairman, Ranking Member Capuano, and members of the subcommittee. My name is Stef Zielezienski, and I am senior vice president and general counsel of the American Insurance Association.

AIA members write property and casualty insurance across the country and around the world. Our membership is diverse and includes U.S. insurers that write insurance only within the United States, U.S. insurers that write inside and outside the United States, and insurers that are U.S. subsidiaries of multinational insurers. As a result, while our focus is on the property and casualty lines of business, our perspective is grounded in our diversity.

AIA strongly supported the establishment of FIO and worked with the Congress to create it. We continue to support its mission, particularly in helping to promote regulatory advances at home and abroad that will improve competitive markets.

As FIO prepared its report, AIA submitted extensive comments that recommended: first, that FIO study the extent to which State rate and form regulation undermines competition, decreases consumer choice, and detracts from the goals of financial solvency oversight; second, that FIO use the report as an opportunity to identify and facilitate uniformity of State regulation; third, that FIO vigorously implement its Dodd-Frank responsibilities, take a leadership role for the United States on international regulatory modernization initiatives and work with States, the NAIC, and Federal financial regulators to present a single, unified U.S. voice to preserve U.S. competitiveness and to promote sound regulatory policy.

We are pleased that the report advances our three recommendations. With regard to rate regulation, FIO acknowledges the evidence that personal lines rate regulation has been counterproductive and calls for the States to identify rate regulatory practices that best foster competitive markets.

At the same time, however, the report contemplates the adoption of uniform Federal standards for use of risk assessment tools. Further regulation of a company's use of risk classification assessment is nothing more than rate regulation by another name. If insurance rate regulation is harmful, it should be jettisoned in favor of competitive pricing and not be reintroduced in the form of national risk classification standards.

On the issue of government product regulation, AIA concurs with FIO's call to the States to "streamline and improve the regulation of commercial products." Establishing or broadening the interstate

compact to encompass commercial lines policy forms is a recommendation worth exploring, particularly if it leads to a shorter timeline for the introduction of new commercial policy forms into the marketplace.

AIA also supports FIO's call for increased uniformity in State market conduct examination standards and for establishing requirements for contract examiners, assuming, of course, that the standards themselves recognize the benefits of diverse business plans among insurers.

Finally, it is critically important that FIO carry out its important Dodd-Frank mission for enhancing the prudential supervision of insurers internationally and to work together with the NAIC, States, and Federal financial services agencies to present a unified U.S. perspective.

While FIO has a clear role on international prudential matters and initiatives, it also participates domestically with the State regulatory representative as an adviser to the Financial Stability Oversight Council and makes recommendations regarding potential insurer designations to the Council.

It is therefore imperative that the U.S. contingent coordinate both here and abroad on policy matters that may shape the future of U.S. insurance regulation. Our perspective is grounded in the recent financial crisis and the ongoing implementation of Dodd-Frank. As a result of these events, insurers must manage their businesses in a turbulent, tripartite environment involving the States, the Federal Government, and our international trade partners.

Capital standards for insurers, systemic risk oversight, accounting principles, and group-wide supervision are the tip of the iceberg, but hardly the whole iceberg itself. In carrying out these discussions in each of the three regulatory environments, FIO must be careful to advance a consistent and balanced position that removes barriers to U.S. competitiveness, while at the same time preserving the domestic laws and regulations that currently work for insurers and consumers.

That is certainly easier said than done due to the existing statutory limitations that apply to FIO's role in developing, negotiating, and implementing any new rules. But FIO's role is no less crucial even with those limitations in place. The stakes are high, and we must all pull in the same direction to get it right.

Thank you very much.

[The prepared statement of Mr. Zielezienski can be found on page 134 of the appendix.]

Mr. LUETKEMEYER. Thank you, Mr. Zielezienski. I appreciate your testimony.

We have votes called, I understand, about 1:10. So with that in mind, I am going to defer my questions to the end. I think Mr. Capuano has done the same. And we are going to go to Mr. Stivers, the gentlemen from Ohio, to begin the questions.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate that.

My first question is for Mr. Hughes. It was alluded to in Director McRaith's report, but can you talk about the benefit of the interstate compact to life and health companies that happen to have ho-

mogenous risk, as far as benefit to customers of products being able to make it to market sooner and things like that?

Mr. HUGHES. I would be glad to. The compact has certainly been a very positive step forward for State regulators. One of the frustrations that we have had over the years is in product approval. The timing really works against us. We have been a big supporter of the compact, but a bit frustrated that large States like New York and California, after a number of years, still haven't gotten on board with it.

Mr. STIVERS. That is unfortunate. I was the sponsor in Ohio. We are proud to be members of it. But some of the big States have not joined.

Mr. HUGHES. They have not.

Mr. STIVERS. And that is one of the problems, but it certainly has streamlined things and made life easier for your customers and people who want to buy life insurance. Is that correct?

Mr. HUGHES. It has, indeed.

Mr. STIVERS. Great. My follow-up to that is for Mr. Restrepo. So given that property and casualty insurance does not have homogenous risk—in fact, it has very heterogeneous risk—are there things that can be done where the States come together, much like they did in the interstate compact for life and health? Because certainly I live in Ohio, like you do. And, by the way, your company is in Joyce Beatty's district now, but you were in my district for a couple of years, and it is a great company, but you guys insure a lot of very different risks.

I don't want our customers in Ohio paying for coastal exposure in Florida. So are there other things we can do inside property and casualty, inside the State-based system that might benefit customers in the way that the compact has for—or for life and health?

Mr. RESTREPO. Both as an industry and as a company, we continue to work with the local State regulators to have pricing and products in place that recognize the realities of those local marketplaces. And as you say, Ohio is very different than Florida and requires different solutions, and Florida requires different solutions.

So working within the existing system, we have significantly improved our pricing precision, with much more sophisticated pricing. When I started in the business 40 years ago, there were just a couple of price options for homeowners. Now, there are thousands. And there are probably more price points for auto insurance in this country than there are drivers.

Mr. STIVERS. And markets like Ohio and—

Mr. RESTREPO. Much more sophisticated.

Mr. STIVERS. —Illinois that allow you to price your product in what—

Mr. RESTREPO. The regulatory system in Illinois really promotes competition. New carriers want to be there, want to compete. It is a very competitive marketplace.

Mr. STIVERS. Thank you. The follow-up I have to that is, since now all of you are regulated by—or could be regulated by Federal entities, the Fed and others, from your perspective—and anybody can answer this—I asked Director McRaith whether there was true coordination between the FIO, the Fed, and the SEC, with regard to having a singular voice both domestically and internationally.

He does a few conference calls, which I certainly appreciate, but I am not sure I feel comfortable that there is a process in place to really create a singular voice, because when there is a disagreement, who wins? And I don't think we know that yet.

Does anybody have an opinion on that? And I only have a minute and 22 seconds left, so I will take it to volunteers. Mr. Nutter?

Mr. NUTTER. Mr. Stivers, a comment that we would make is that with the introduction of the Federal Reserve into this process and the driver being the Financial Stability Board at the IAIS, I must admit, for many of us, it has become much more opaque about how you engage those regulators or whether or not at the Financial Stability Board there is really insurance expertise that is represented there. So there is—

Mr. STIVERS. Clearly not as a voting member. And you make that point very well. And I think that—let me ask just a yes-or-no question. Are there any of you who believe that we would benefit from a much more clear process as to how we create a singular voice, both domestically and internationally? Do you think we would benefit from a better process? Raise your hand if you think so.

Mr. HUGHES. Absolutely, yes.

Mr. STIVERS. Does anybody disagree with that statement? Great, thank you. I think that is really the heart of where I think we need to go, because several of you made this point very, very well about how overlapping and conflicting regulation could really hurt our competitiveness. I am also very worried that a lot of the Europeans and international folks have a singular voice and we do not. And we also have a dominant share of the insurance market, and it could really put our American companies that want to do business internationally at a huge competitive disadvantage, if the structure is built around a foreign model.

And so, thank you for being here. Thanks for what you guys do. I had a very brief time to ask questions, but I appreciate those of you who responded. Thanks for being here, Mr. Restrepo.

Mr. LUETKEMEYER. I thank the gentleman. We will now go to the gentlelady from Ohio, Mrs. Beatty.

Mrs. BEATTY. Thank you, Mr. Chairman, and Mr. Ranking Member. We have heard a lot about capital standards this afternoon. Mr. Hughes, if our goal is to have the best prudential supervision and the most effective regulation of the financial services industry, does it make sense to apply bank capital standards to insurance companies? And would it make more sense to apply insurance-based standards to insurance companies?

Mr. HUGHES. We feel very strongly that the only standards that ought to be applied to an insurance enterprise are insurance-based standards. And that has been our great frustration at the moment with the Federal Reserve's interpretation of Dodd-Frank, which is sending us in the other direction. I know you have had discussions with some of your constituents on that point, and we are working very hard with this body and the Senate to see if we can correct that.

Mrs. BEATTY. Thank you. Let me ask one other question. As I was reading, Mr. Restrepo, in your testimony, let me, first, thank you for the statement about the questions that we should be asking, best standards for good regulation and good regulators, and

where can the current system be improved. That is a great starting point, I think, for me. What is it that we can do?

So hearing your testimony from all of you today is very helpful. But my question to you, Mr. Restrepo, is, if the Federal Reserve proposes a bank capital standard for insurance companies under supervision, while the State insurance regulators enforce an insurance standard, are you concerned about any confusion and uncertainty that could result from that?

Mr. RESTREPO. I am very much concerned. You could rapidly go from a hybrid structure to a hydra structure, with multiple heads you are dealing with, and multiple heads will certainly confuse the marketplace.

We are a very strong industry and really don't need the kind of standards—certainly the single standards that are being talked about. It is a diverse industry. We all have different risk profiles, different capital requirements, and those solutions—or those issues are best addressed locally.

Mrs. BEATTY. With that—and from hybrid to hydra—is it plausible that there could arise a situation in which two different regulators are trying to enforce two different incompatible standards on the same company?

Mr. RESTREPO. No question.

Mrs. BEATTY. Okay.

Mr. RESTREPO. In fact, that is bound to happen.

Mrs. BEATTY. Thank you. That was very helpful. And I yield back my time, Mr. Chairman.

Mr. LUETKEMEYER. Okay. Next, we have the ranking member of the subcommittee, the gentleman from Massachusetts, the Boston Red Sox's greatest fan here in the Capitol, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

While the gentlelady from Ohio is here, based on your early questions, I do—there are some misinformed people in America who wouldn't mind if Ohio State's football program shut down. I am not one of them, of course, but there are those who might be—not, of course—

Mrs. BEATTY. Am I supposed to say thank you to that or am I supposed to pause, Mr. Chairman?

Mr. LUETKEMEYER. Remember, he is the ranking member.

Mrs. BEATTY. Then, thank you.

Mr. CAPUANO. Yes, big job.

First of all, gentlemen, thank you all very much for being here and putting up with all this. And, by the way, is there anybody in the audience who has not testified who would like to, because—as I said earlier, this is an interesting discussion. And I am tempted—I don't—I didn't hear anybody who actually said that you would rather have the Fed doing this than FIO. I just want to be clear that I didn't hear anybody say that. Did you? Good, because this was part of the discussion we had when we did Dodd-Frank. If we didn't do something like this, the Fed or somebody in the banking industry would step in and do it. It was either something like this or banking regulators doing it.

And I think all of us agree that banking regulators are fine and wonderful people in banking issues. And they may have some interest in some of the things that some of you companies do, but in

general, insurance is a different animal and deserves different treatment. And that is what this was all about.

I am tempted, to be perfectly honest, to ask each of you whether you think that any individual company who wished to have an optional Federal charter should be able to do so, but because I respect you all and don't want to position you too much, I won't do that. But that is a discussion for another time.

I think that a lot of the things that you have said and others have said argue strongly in favor of allowing a company—if they so choose—and allowing companies to choose not to, to do it—again, similar to what banking does. There are banks that have chosen to do State charters, and there are banks that have chosen to do Federal charters, but that is a different issue.

I am, however, interested, because we will have this discussion. There are some of my colleagues here who hate the concept that FIO even exists. They hate the concept of them even asking questions and trying to put a focus on this discussion. And for my purposes, I would like to ask each of you, if you had a choice, if I made you emperor of the universe, and you could unilaterally make this decision, now, you only have two choices here. I am not going to give you multiple choices, because that gets too complicated, and I don't have that choice. I get to vote red or green, so you may as well vote red or green.

If your choice was to keep FIO as it is, pretty much with its authority or limited authority as it is, to have these discussions, would you repeal it outright? Would you repeal it? Or would you keep it as is? And, Mr. Cimino, I may as well start with you.

Mr. CIMINO. Yes, we would support a strong, effective FIO as it currently stands.

Mr. CAPUANO. Mr. Ehlert?

Mr. EHLERT. I think FIO definitely has a role in the international market. And we would support FIO in that market, as well.

Mr. CAPUANO. Mr. Hughes?

Mr. HUGHES. We absolutely support FIO.

Mr. CAPUANO. Mr. Jensen?

Mr. JENSEN. FIO as it stands.

Mr. CAPUANO. Mr. Nutter?

Mr. NUTTER. FIO, yes, with the authority they have for covered agreements in particular.

Mr. CAPUANO. Mr. Restrepo?

Mr. RESTREPO. FIO as it is.

Mr. CAPUANO. Mr. Sinder?

Mr. SINDER. We have been big supporters of FIO since day one.

Mr. CAPUANO. Mr. Zielezienski?

Mr. ZIELEZIENSKI. Yes, we support FIO, and believe it has a crucial international role.

Mr. CAPUANO. That is all I wanted to hear, because to be perfectly honest, we will continue this discussion about how—because, again, as I said earlier—I am sure you all hear me—I do believe that slowly but surely over time we are going to come to a more federalized system. I don't think we will ever get to a fully federalized system. I don't even think I really want that.

But I think we are going to go that way. We have already started. You know that as well as I do. It is inevitable, and with your help, we will be able to get there in a thoughtful way as opposed to a fits and starts way.

My hope is that it gets done absent the financial crisis. We all know that financial crises—and there will be another one someday, hopefully not in my lifetime, but there will be—don't always result in the best reaction by Congress. I think things are better done in a thoughtful manner, and my hope is that FIO allows us or encourages us to have this discussion as we move forward, and I hope that you all participate in that. And again, thank you for what you have done here today.

Mr. LUETKEMEYER. I thank the gentleman. And you notice today so far that our panel has had some softball questions from us. We recognize you have us outnumbered, so we are going to behave ourselves.

And with that, we go to the gentleman from California, if he is ready, Mr. Royce.

Mr. ROYCE. I want to thank Mr. Sinder for his statement on the IRS move to issue supplemental regulations, implementing FATCA. Non-cash-value insurance products are not vehicles for tax evasion and should not be treated as such. I have mentioned this issue to the FIO and to the Treasury. And I would like to work with you to ensure that the reporting requirements do not apply to these products.

But I am sure many of you attend NAIC meetings on a regular basis, and I did want to ask you a question, Mr. Hughes. I was hoping you could comment on whether NAIC committees and subcommittees all always follow the open meetings policy mentioned in my questioning to the first panel, and specifically, if you or a member of your trade participated in the executive committee meeting via conference call on October 25th regarding the master death file, and do you feel that meeting was open? And I would ask if any others would care to comment?

Mr. HUGHES. You put your finger on an issue that is significant to us. The role of the NAIC has grown substantially over the years, and governance has not kept pace with it. So we are very strong believers that the NAIC needs to have due process and accountability. The things it is doing today, whether you are talking about open meetings or pushing for accreditation standards that essentially have the force and effect of law, we think it is imperative that the NAIC do something along the lines of what you would have in any State, which is your administrative due process statute. So we are very strong proponents of engaging the NAIC in a constructive discussion on how to improve governance.

Mr. ROYCE. I think transparency is important and it is done at the State level. And it is not done here. The other question, Mr. Hughes, and I would ask you and others if you could please outline in your view what the costs are to consumers of the lack of uniformity in State insurance regulation, because I remember well the original quote by the original NAIC Commissioner back in the late 1800s about the ideal of having for the consumer—having uniform regulation everywhere.

That was the original goal. That goal has never been achieved. What about the costs to the consumer as a consequence?

Mr. HUGHES. From our perspective, the costs are significant, and they are passed along in our pricing to consumers. You may recall that former FDIC Chair Sheila Bair did a study some years ago that analyzed this, and reached the same conclusion that McKinsey did, that there are substantial cost savings that could be realized if the system were uniform from one jurisdiction to another.

Mr. ROYCE. Let me ask Mr. Sinder that same question, should he want to comment on it.

Mr. SINDER. I agree completely. One of the issues is, at some level, the NAIC is a confederacy. No one is bound by the model rules that they issue. And so without the Federal pressure, it is harder for them to achieve a harmonious, uniform result.

Mr. ROYCE. Mr. Cimino, would you like to comment on that, as well?

Mr. CIMINO. Yes, I would be happy to. Thank you for the question. Given the patchwork system we have in place here, we ultimately have companies that aren't able to necessarily offer products throughout the Nation. And so even though there might be model laws in place, States may adopt them in some form of derivative, so ultimately it raises barriers and increases costs.

So not only are consumers not able to necessarily purchase the products that might suit their needs, but it ultimately raises barriers, which forces out competitors in the marketplace. And it is that competitive pressure that lowers the prices and ultimately serves those consumers.

Mr. ROYCE. So, you have both factors. Would you hazard a guess in terms of what the costs are to the consumer, in terms of the first aspect of the lack of uniformity?

Mr. CIMINO. I don't know if I could quantify that cost for you, sir.

Mr. ROYCE. Yes, sir?

Mr. ZIELEZIENSKI. There are certainly costs of non-uniformity. But I would like to point out that even if it is uniform, there is inconsistent application. And let's just talk about product review for a minute.

I remember doing an internal survey of AIA member companies probably about a decade ago to try to determine how long it took to get a product to market. And what I learned was there are costs associated with such a lengthy product approval delay that the product never made it to market.

So not only are there costs to consumers, but there are costs to consumers of not having the product option even available because the time it takes to review it and approve it at the State level is not worth the investment for the company.

Mr. ROYCE. It is interesting. If you go back to the McCarran-Ferguson decision, the decision also said that insurance is interstate commerce, right? It is part of the decision. And if you go back to the original reason we gave up on the Articles of Confederation, maybe some of the confederates in Congress would still argue this point, but the reason we have an interstate commerce clause is because of what was happening between the States with respect to barriers of entry.

And it became very clear to the architects of this republic that the reason it didn't work was because we hadn't created a national market. Instead, we had these tariffs, these barriers to entry at every State border, and the consumers were the losers for it.

So the concept behind our system of federalism was that we would establish one market in the United States, and we are still struggling with the fact that, with respect to insurance, we have built in a great disadvantage for our consumers because of these barrier to entry problems which create then something of a lack of competition on one hand. You don't have the efficiencies that would come from a national market driving down prices. And it is time we, I think, have a paradigm shift in terms of how we view this and how we come together in order to get some of these economies of scale and a more competitive market for insurance to benefit our consumers.

Thank you very much, Mr. Chairman. I appreciate the time.

Mr. LUETKEMEYER. Thank you. We have a few statements that we need to add to the record here: the National Conference of Insurance Legislators; the American Academy of Actuaries; the National Association of Professional Surplus Lines Offices; Lloyds of London; and the Insured Retirement Institute.

Without objection, it is so ordered.

And let me just wrap up here with a few remarks and a couple of questions. I think that we have—from the discussion today—seen that FIO's role is still one of evolving into something that we hope will be a benefit to the industry. All of you have made comments with respect to, we would like to see them in their role of protecting our interest internationally, of staying in that role.

And I would just add that you all are in a position to really push the agenda and push back on things. And I would hope that you would encourage them to be leading when it comes time to do something on the international level, from the standpoint—we are the big boys on the block. Why do we have to follow what Europe does or whoever else? Let them follow us. We need to be leading this situation and not allow our industries and our markets to be harmed by something internationally, if we don't like it, then they can conform to us. That would be my suggestion.

From the standpoint of what goes on within our own country here, it has been said most of you don't like the capital standard suggestion from the international folks. A couple of you have made mention of the fact that you—the risk classification standards are something that they need to stay away from.

And I guess my question would be, what is your plan of action against pushing back on areas where you believe that they don't need to be involved, or they seem to make suggestions that they may get involved in? Do you have a plan of action to do that, Mr. Cimino?

Mr. CIMINO. I think it goes to the question that Mr. Stivers was talking a bit about, which is, how do we better coordinate this to make sure we have a unified voice? And I think that most of the folks up on this panel are working hard—

Mr. LUETKEMEYER. It is a pretty unified voice from where I am sitting here, with all of you today. I am just—there needs to be some sort of a coordinated plan. I hope that there is one there.

There is this sense I get that you are coordinated, that you are unified, and that you will work with these folks and push back on areas where you believe that they will be encroaching.

Mr. Hughes in particular, you have some interesting areas where you like what they do, and other areas where you are very concerned about some of the things they do.

Mr. HUGHES. Yes, and I think that the watchword for us is really "consistency."

Mr. LUETKEMEYER. Yes.

Mr. HUGHES. And I think it is incumbent upon the United States—if the world would coalesce around us, I think that would be wonderful. We did weather the crises well, but I think what we have to do is have the FIO, the States, the Federal Reserve, and anybody else that is a stakeholder in this, advocating on the same page with the same message with these international bodies. At the end of the day, we hope that we have that consistency globally that we need and that it doesn't upset our system of regulation.

Mr. LUETKEMEYER. As somebody who was in the business for 35 years, it always gives me some trepidation when I see the Federal Government start to get their nose in the tent. Seeing what has happened here over the last several years, it seems like once the nose is in the tent, the Federal Government never goes away. You have to put up with it from then on.

Mr. Sinder, you had a couple of comments with regards to TRIA that I was kind of curious about. Your group deals with it probably more than the rest of these folks, and I was curious, has the fact that we haven't addressed TRIA as a Congress yet started to affect your members and their ability to not only sell their product, but their clients and their ability to do their business?

Mr. SINDER. Yes, sir, it has. It affects their clients. We are already seeing—for renewals that are coming up now that aren't aligned with the calendar year, there are riders on the policies that say the terrorism coverage will expire on December 31st absent extension of the TRIA program. So we are already seeing it. You have policyholders who are buying partial coverage because they can't get the rest.

Mr. LUETKEMEYER. And, Mr. Hughes, you talked about covered agreements. That is where—I want to go to, I think, Mr. Nutter. Can you give me just a little background on that really quick, exactly what you are talking about and how FIO can be impactful for you?

Mr. NUTTER. You asked a question a minute ago about a plan in dealing with concerns about European-driven capital standards. The Congress included in the Dodd-Frank Act the authority for FIO to enter into covered agreements, so think of them as treaties, not subject to Senate approval, but subject to a whole host of checks and balances, including review by this committee, the House Ways and Means Committee, and the Senate Banking and Senate Finance Committees, both when they are initiated during the course of them, and then when they are concluded, as well as the involvement of the NAIC or the Commissioners in that process.

It clearly is a way to deal with the mutuality that you would want between regulatory officials both in the E.U., in Bermuda and Switzerland, and other major trading partners. So it does seem to

be the one operating authority that FIO has that can deal with issues beyond the narrow issue that is often characterized as dealing with collateral or security on reinsurance transactions.

Mr. LUETKEMEYER. Very good. With that, I am finished with my questions. I think the panel is also finished. I would like to thank each of you for being here today. I appreciate your testimony. It has been very insightful. While we didn't have, perhaps, as many people here as you may have thought, your testimony is extremely important from the standpoint of drawing conclusions from what your industry believes is important, what you want us to focus on, and your priorities so that we can work with you to try and come up with some good solutions here.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, this hearing is adjourned.

[Whereupon, at 1:14 p.m., the hearing was adjourned.]

A P P E N D I X

February 4, 2014

FINANCIAL SERVICES ROUNDTABLE

Committee on Financial Services

Subcommittee on Insurance and Housing

"The Federal Insurance Office's Report on Modernizing Insurance Regulation"

February 4, 2014

Statement Delivered by

Anthony Cimino

Acting Head, Government Affairs

The Financial Services Roundtable

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for the opportunity to appear before you today.

My name is Anthony Cimino, and I am the acting head of government affairs for the Financial Services Roundtable. The Financial Services Roundtable is an advocacy organization for the financial services sector. Our members include the leading banking, insurance, asset management, finance, and credit card companies in America. An important note, FSR represents insurance companies in the life, property and casualty, and reinsurance sector. We bring a comprehensive and sector-wide voice to the important and necessary debate around modernizing the insurance regulatory system.

At FSR, we believe a competitive marketplace provides the best mechanism for financing and growing the American economy. Financial services companies provide the capital, security, and the foundation needed for economic growth in both the domestic and global markets.

We appreciate you holding this important hearing on the Federal Insurance Office's report, *How to Modernize and Improve the System of Insurance Regulation in the United States*, and thank you for the opportunity to testify.

My testimony will (1) detail the need for a strong, effective Federal Insurance Office; (2) identify the principles FSR believes should underpin insurance regulatory modernization; (3) address certain Report recommendations in greater detail; and (4) urge Congress and FIO and NAIC to develop an action plan to spur needed modernization of the insurance regulatory system.

The Existing Regulatory Structure

In the United States, the business of insurance is regulated at the state level, although many federal statutes and regulations also apply to insurance companies. The existing regulatory patchwork relies on a complex web of more than 50 separate state-based regulatory systems and 99 state legislative bodies, each with its own procedures, regulations, and legal definitions of insurance. This structure has deficiencies that should be addressed to further strengthen our market and meet consumers' needs more efficiently. The current regulatory system lacks uniformity and a comprehensive approach across the states.

The Dodd-Frank Act established the Federal Insurance Office (FIO) and charged it with identifying how to improve and modernize insurance regulation. In the December 2013 report, FIO identified actions that both the states and federal government can take to improve the regulatory environment in order to better serve consumers.

To address the lack of uniformity and short-comings in the existing insurance regulatory system, the Report makes eighteen recommendations to the states to modernize insurance in the near-term and nine recommendations where there is a role for direct federal involvement. What matters most is what comes next, and we believe that starts with an effective and robust Federal Office of Insurance.

The Federal Insurance Office and Insurance Regulation

FSR shares the view of many that insurance regulation can be significantly improved. To that end, FSR supports a strong, effective Federal Insurance Office. To advance reform beyond this point, FIO must be an effective and adequately-resourced force that can work with state regulators and be a leader in the federal government, state and international regulators.

A strong, effective FIO can advance the modernization effort by examining insurance reform on a broad, national scale, interacting with state regulators on a consistent and collaborative basis, and objectively measuring progress. FIO is well positioned to coordinate and understands how the broader insurance regulatory environment affects insurers and consumers. Structurally, FIO can fill this role. It can assist in evaluating whether state actions alone can achieve sufficient reform or whether other means, such as through interstate compacts or federal legislation, additional measures are needed. Individual state regulators will, rightly so, focus on their own state's needs and do not have the responsibility or the charter to act nationally and holistically. However, bringing more uniformity and consistency to the regulation that exists across the country will benefit consumers.

In addition, a strong, effective FIO should serve as an educational and coordinating resource to the federal government as it becomes more involved in the insurance sector. The Federal Reserve, for instance, will oversee certain insurers that qualify as savings and loan holding companies or have been designated by the Financial Stability Oversight Council (FSOC) as Systemically Important Financial Institutions (SIFIs). The Federal Reserve has historically supervised banks and must now develop expertise in the insurance sector, which has vastly different risk, capital, and business models than banking institutions. FIO has a clear role in serving as that scholastic resource to the Federal Reserve and other federal agencies that may undertake actions that impact the insurance sector.

Furthermore, international forums and standard-setting efforts are influencing U.S. insurance regulation. FIO must be a strong a voice representing U.S. interests. FIO currently sits on the International Association of Insurance Supervisors' Executive and Financial Stability Committees and chairs its technical Committee. In addition to FIO, representatives from the NAIC and the Federal Reserve participate in the IAIS. If U.S. representatives do not coordinate effectively, the U.S. voice and influence could be diluted or fragmented, undermining our ability to assert U.S. interests and to assure a level playing field for companies and consumers around the globe. An effective FIO can, and should, facilitate that coordination and ensure that the U.S. interests are advanced.

This will be equally important as the Financial Stability Board (FSB), in consultation with the IAIS policy methodology and policy measures, identifies globally systemic insurance institutions. As this process continues to unfold, it will be critical that the U.S. has a strong voice to influence consideration and any designation decisions.

Principles of Reform

As Congress considers reform, FSR urges policymakers use the following principles to underpin necessary modernization efforts: (1) establish uniform regulatory standards across the states; (2) facilitate open and competitive markets; (3) and implement effective, streamlined regulations.

Uniform Regulatory Standards

Uniformity is a critical aspect of effective insurance regulation. Different standards and treatment across states increase compliance costs that drive prices up for consumers and may restrict product offerings. Although the mechanism exists to adopt uniform standards, it has not been effective. The NAIC has, since its inaugural meeting in 1871, posited its goal of uniform standards, but because its model laws and regulations must be adopted by each state's legislature or insurance department, they are often not adopted uniformly or across the country. While considering reforms, FIO should elaborate on a set of uniform standards that are widely acknowledged to bring greater efficiency to consumers and carriers with a focus on speed to market and competition.

Open and Competitive Markets

Regulatory policy should encourage innovation in product offerings and spur healthy price competition. Consumers benefit from competition and the ability to choose the products and services that suit their needs and priced appropriately because competitive market pressure.

Effective, Streamlined Regulation

The FIO Report recommends actions the states and the federal government can take to improve insurance regulation. While FSR supports improved regulation, we caution that the model articulated in the Report could lead to increased dual regulation, which may result in duplicative, inconsistent, or possibly even conflicting demands. This would be an unproductive and burdensome outcome for insurers and their consumers, as costs would increase and product offerings restricted. FSR urges Congress and FIO to ensure that needed reforms do not lead to increased dual regulation.

Report Recommendations

For purposes of today's testimony, I will not address each recommendation, but rather focus on a few areas.

The Report includes a number of recommendations that FSR supports and believes would have a positive impact on the market and consumers in the near term.

- *Capital Standards* – FIO notes in its Report the different business model and risk profile of insurers compared to banking institutions, and as a result the need to craft different and appropriate capital standards for insurers. For example, while banks rely on a shorter-term funding model and have greater exposure to interest rate and credit risk, insurers use a longer-term funding model and invest in assets that match the duration of their liabilities. FSR represents both banks and insurance companies and is uniquely positioned to understand this difference and the need to apply different capital standards for each sector.

  As the Federal Reserve provides prudential oversight to insurers that have banking operations and insurers that are designated as SIFIs, FSR supports efforts to tailor capital standards to insurers' unique business model and risk profile.

- *Product Approval* – FSR agrees with FIO's recommendation to improve the product approval process. Establishing a more streamlined and uniform nationally standardized process can improve speed to market and innovation. Coupled with expanding the eligible product lines, this reform, if implemented appropriately, can increase consumer choice and lower consumer costs.

- *NARAB II* – FSR supports FIO's recommendation that Congress adopt legislation on the National Association of Registered Agents and Brokers. This legislation would establish a multi-state licensing process for agents and brokers, improving the process for agent licensing.

- *Natural Catastrophe Mitigation* – FSR agrees that addressing natural catastrophe risk and damage is necessary. Best practices surrounding building codes and construction standards, as well as incentives for mitigation efforts should be identified and adopted.

FSR would also like to note issues where we look forward to development of FIO's plans.

- *Rates and Actuarial Pricing* – The Report recommends states examine the impact of different rate regulation regimes to identify the optimal practices. In addition, the Report recommends FIO work with the states to establish a pilot program for rate regulation to maximize insurers offering products. FSR believes that a competitive environment that increases competition ultimately drives prices down and best serves consumers.

  FIO points out that studies suggest rate regulation may adversely affect market supply and pricing and that rate regulation should ensure solvency and encourage competition as much as possible. We will look for more guidance from the FIO on how it might advance this objective.

  Credit for Reinsurance and Covered Agreements – The Report recommends the Treasury and United States Trade Representative pursue a covered agreement on reinsurance

collateral requirements to achieve national uniform treatment of reinsurers. FIO's desire to achieve this uniform treatment is welcome, but at this time the contours of such an agreement are unknown. FSR requests the opportunity to work with FIO and other stakeholders to shape the contents of such an agreement to achieve the desired goal.

The Path Forward

FSR commends FIO for its recommendations on how to modernize the insurance regulatory system and looks forward to working to advance the process. We share FIO's desire to improve the insurance regulatory system, and we are eager to learn more about the policy and process FIO intends to use to further its recommendations.

To the extent Congress agrees with certain recommendations, or has its own reforms to advance, FSR recommends it work with FIO to put in place metrics and deadlines for the states to adopt standards or conduct activities.

The patchwork insurance regulatory system we have today can be improved to serve the insurers and, most importantly, their consumers. Currently, the system lacks uniformity and is burdened by costly and sometimes inconsistent regulations that stifle competition, increase consumers' costs and decrease consumers' access to products and services.

FSR urges Congress to work with FIO, the states, and other interested parties, to chart the way forward.

Conclusion

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for the opportunity to testify today.

Insurance is an integral part of the U.S. and global economy, touching the lives of nearly everyone. You are undertaking a critical effort in building on FIO's Report to modernize the insurance regulatory system. At this point many questions remain, but we look forward to working together to resolving those issues and putting in place an insurance regulatory regime that better serves our consumers.

Thank you. I am happy to answer your questions.

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of

Paul Ehlert

President

Germania Insurance

on behalf of the

National Association of Mutual Insurance Companies

to the

United States House of Representatives

Financial Services Subcommittee on Housing and Insurance

Hearing on

"The Federal Insurance Office's Report on Modernizing Insurance"

February 4, 2014

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the House Financial Services Subcommittee on Housing and Insurance on the Federal Insurance Office's regulatory modernization report.

We represent the interests and concerns of 1,400 property/casualty insurance companies serving more than 135 million auto, home and business policyholders, with more than $196 billion in premiums accounting for 50 percent of the automobile/ homeowners market and 31 percent of the commercial insurance market. We are the largest and most diverse property/casualty trade association in the country, with regional and local mutual insurance companies on main streets across America joining many of the country's largest national insurers who also call NAMIC their home. More than 200,000 people are employed by NAMIC members.

Background

The Federal Insurance Office (FIO) released on December 12, 2013, its long overdue report on insurance modernization. The report, "How to Modernize and Improve the System of Insurance Regulation in the United States," includes recommendations for "near-term reform for the States" concerning safety, soundness, and capital adequacy; insurance company resolution practices; and marketplace regulation. The report also outlines recommendations for "direct Federal involvement in regulation."

The report is not overly critical of the state-based regulatory process. "In the short term, the U.S. system of insurance regulation can be modernized and improved by a combination of steps by the states and certain actions by the federal government," it asserts. However, it does include a threat that federal involvement "will be necessary ... [t]o address the inefficiencies and lack of uniformity in the state regulatory system" in the event uniformity is not achieved at the state level. Specifically, the report is critical of the "uneven" progress in modernization at the state level and asserts that if "states fail to accomplish necessary modernization reforms in the near term, Congress should strongly consider direct federal involvement."

The report represents a stepping-off point for the discussion about the next steps that can be taken to improve the system of insurance regulation in the United States. In NAMIC's view, nothing in the report's recommendations comes as a great surprise. There are certain conclusions of the report that NAMIC would agree with: regulation can be too costly and often too complex, the regulation of rates should be reformed, and disaster mitigation, such as building codes, is of great importance. There are other areas that raise concerns, including the report's implicit assumption that federal involvement will automatically translate into increased regulatory efficiency and efficacy as well as its discussion of risk classification, especially in regard to credit-based insurance scoring.

Report Findings and Recommendations

In considering the need for regulatory modernization in the U.S., the report observes that the costs of regulation for insurers are comparatively high and "the absence of uniformity in the ... system creates inefficiencies and burdens for consumers, insurers, and the international community." It also states that regulation would be "... much less costly, much less prone to arbitrage, and much easier to negotiate internationally for more efficient and effective oversight of the insurance sector if U.S. insurance regulation had greater uniformity and predictability." Finally, the report makes the claim that the realities of internationally active, complex financial institutions with insurance operations, as well as the experience with AIG during the recent financial crisis, "compels the conclusion that federal involvement of some kind is necessary."

The twin goals of efficiency and uniformity in U.S. insurance regulation are shared by NAMIC. However, we would caution against concluding too quickly that these goals will be served by the inclusion of the federal government into the mix. For example, it is not clear that the report puts the near-collapse of AIG in the proper context – on the one hand suggesting that the company's complexity demonstrates the need for federal involvement while on the other, correctly observing that the Federal Office of Thrift Supervision (OTS) "rarely conducted examinations of AIG Financial Product's activities." It was the OTS that held responsibility for oversight at the holding company level. In general then, the report may not have gone far enough in recognizing some of the limitations – and, indeed, the failures – of federal regulation.

The report succinctly highlights many of the unique features of the business of insurance that NAMIC has long argued set the industry apart from others in financial services. For example, the report observes that insurers typically have less leverage than banks and generally are not likely to pose a systemic risk. Additionally, the report notes that another distinguishing feature is that insurers do not typically rely on short-term funding and are not susceptible to runs or liquidity stresses.

While the report points to the increased costs of the state-based insurance regulatory system, it also acknowledges the local nature of many insurance products and the cost and complexity of setting up a federal regulatory apparatus capable of effectuating robust professional supervision for all or part of the insurance industry. Therefore, the report concludes that the proper balance is maintenance of the state-based regulatory system with federal involvement in areas where warranted. Based on a determination that in the short-run "the U.S. system of insurance regulation can be modernized and improved by a combination of steps by the states and certain actions by the federal government," the report makes a series of recommendations for 18 state-based reforms and nine areas for direct federal involvement in insurance regulation.

Below are NAMIC's views on the report's recommendations that are of greatest concern to our association and its members.

Capital Adequacy/Solvency

FIO Recommendations: (1) For material solvency oversight decisions of a discretionary nature, states should develop and implement a process that obligates the appropriate state regulator to first obtain the consent of regulators from other states in which the subject insurer operates; (2) To improve consistency of solvency oversight, states should establish an independent, third-party review mechanism for the National Association of Insurance Commissioners Financial Regulation Standards Accreditation Program.

The report notes the strength of the underlying risk-based capital (RBC) methodology and the attempt to achieve solvency oversight consistency through the National Association of Insurance Commissioners (NAIC) Financial Regulation Standards Accreditation Program. However, the report points to uneven application of the standards and stresses the importance of a uniform set of rules for accounting and capital standards. As such, the report recommends with respect to significant solvency oversight matters that regulators establish a system whereby a domestic state regulator would obtain the consent of regulators from other states in which an insurer operates before approving any deviations from solvency standards.

The report also recommends subjecting the accreditation program to independent, third-party review to bring an unbiased perspective on the uniform adoption and implementation of capital rules and other standards.

NAMIC supports the concept of uniformity of solvency regulation, but the consent recommendation has numerous practical challenges that run contrary to the other goals of modernization and efficiency. For example, it is not at all obvious how it would be more efficient to clear discretionary regulatory decisions regarding solvency with regulators from all jurisdictions in which the company in question does business. In addition, it would likely not accomplish the uniformity intended. This might be better solved with stringent identification of critical elements required for accreditation of state departments of insurance related to risk-based capital model laws and strict application of the requirement that adoption of model laws be "substantially similar." NAMIC would welcome third-party review of the accreditation process as well as a more open, precedent-based, and documented evaluation process.

FIO Recommendation: States should develop a uniform and transparent solvency oversight regime for the transfer of risk to reinsurance captives.

The report points to the expanding use of captive reinsurance or special purpose vehicles among the life insurance industry, as well as the concerns raised by some regulators and stakeholders over the uniformity, transparency, and capital adequacy of these mechanisms. If an insurer is to receive credit against a capital or reserve requirement because of risk transferred to an insurance captive, the report insists that the rules governing the quality and quantity of assets of the captive should be uniform and the oversight sufficiently robust and transparent in order to prevent arbitrage. To achieve that goal, the FIO recommends that states develop and adopt a uniform capital

requirement for reinsurance captives, robust standards for transparency, and proper disclosure in the financial statements of the ceding insurer. In addition, it recommends the adoption of nationally consistent standards for oversight of the reinsurance captive industry as part of the NAIC accreditation program.

The use of captives to satisfy reserve requirements is found among life insurers due to the difficulties inherent in the formulaic statutory reserving system they are required to utilize. The NAIC is making efforts to revise and reform that system with a principles-based reserving system, but there will always be product innovations, and the regulatory system may struggle to maintain pace with industry practice. This is not an issue directly impacting most property/casualty insurers, but it is an issue that creates an unlevel playing field between life insurers and other financial institutions if the reserve requirements are out of synch with economic capital requirements.

FIO Recommendation: State-based solvency oversight and capital adequacy regimes should converge toward best practices and uniform standards.

The report discusses the limitations of the RBC program, citing criticism that it is an overly prescriptive, one-size-fits-all approach and fails to account for risks such as catastrophe and operational risks. As state regulators review and enhance standards, the report recommends that they integrate best practices, standards, and principles developed through international consensus.

The report notes the implementation of the Own Risk and Solvency Assessment and recommends that states develop a uniform national standard for independent contractors to assist states with the evaluation of insurer self-assessments, as well as a means to assure that state regulators adequately understand, and are accountable for, the work and findings of such contracted specialists.

While supportive of a uniform system for capital adequacy, NAMIC contends that operational risk is not actually missing from current RBC calculations but is already provided for in other RBC factors. Consequently, attempts to include a segmented factor for operational risk will require adjustment of other RBC calculations. The perceived differences in international principles for capital and the current U.S. system are often matters of explanation, not substantive differences.

FIO Recommendation: States should move forward cautiously with the implementation of principles-based reserving and condition it upon: (1) The establishment of consistent, binding guidelines to govern regulatory practices that determine whether a domestic insurer complies with accounting and solvency requirements; and (2) Attracting and retaining supervisory resources and developing uniform guidelines to monitor supervisory review of principles-based reserving.

The report details criticism of the use of the formula prescribed by the Model Standard Valuation Law for calculation of life insurance reserves, including its static and conservative assumptions, inability to accurately reflect business practices of individual

insurers, and failure to capture specific risks. The report notes the ongoing efforts of the NAIC to develop principles-based reserving (PBR) for life insurers.

The report notes that reserve requirements should properly reflect current mortality rates, the insurer's business model, and its particular risk profile, but that substantial concerns arise with the prospect of a wholesale adoption of PBR. As a result, the report recommended that states move cautiously with implementation of PBR.

As in the segment on reinsurance captives, this recommendation primarily relates to life and annuity reserving practices. The NAIC is making efforts to revise and reform that system with a principles-based reserving system, but there will always be product innovations, and the regulatory system may struggle to maintain pace with industry practice. This is not an issue directly impacting most property/casualty insurers, but it is an issue that creates an unlevel playing field between life insurers and other financial institutions if the reserve requirements are out of synch with economic capital requirements.

Credit for Reinsurance

FIO Recommendation: To afford nationally uniform treatment of reinsurers, the FIO recommends that Treasury and the United States Trade Representative (USTR) pursue a covered agreement for reinsurance collateral requirements based on the National Association of Insurance Commissioners Credit for Reinsurance Model Law and Regulation.

The report observes that non-U.S. reinsurers account for more than half of the reinsurance premium volume that is ceded by U.S.-based insurers, yet state insurance regulators do not have direct oversight over non-U.S. reinsurers. Historically, reinsurers that are not licensed, accredited, or approved by the regulator of the state have had to post qualifying collateral equal to 100 percent of the actuarially estimated reinsurance liabilities. This requirement has been an issue of significant debate. While supportive of the goal of the NAIC Credit for Reinsurance Model Law and Regulation, the report expresses jurisdictional concerns between states and between foreign countries and states, as well as concerns about over-reliance on credit reporting agencies. Given the international complexity of the issue and the possibility of inconsistent adoption of the model language by the states, the FIO believes that credit for reinsurance is a prime topic for consolidation into a covered agreement.

In enacting the Dodd-Frank Act (DFA), the FIO and the United States Trade Representative (USTR) are authorized to jointly negotiate and enter into such "covered agreements." Further, the FIO is given authority to determine if a state law or regulation is preempted by the covered agreement. The DFA requires that prior to initiating negotiations for a covered agreement Treasury and the USTR jointly consult with Congress regarding the nature of the agreement; how it will achieve the applicable purposes, policies, priorities, and objectives; and its implementation. If the FIO and the USTR initiate negotiations for a covered agreement addressing reinsurance collateral it

would be the first test of the DFA authority in this matter and would set in motion a number of new authorities and duties for the FIO.

While NAMIC recognizes the need for consistency in the treatment of international reinsurers, we have taken a cautious but neutral position on the reduction of collateral requirements for reinsurance written in the U.S. by non-U.S. reinsurers. While reinsurance does seem appropriate for treaty-based action considering the cross-jurisdictional impacts, the use of a "covered agreement" to preempt state law seems a dangerous precedent for the FIO to pursue. NAMIC will not oppose this effort for reinsurance purposes but would be very concerned if the "covered agreement" approach to insurance regulatory and legal requirements were to move beyond this limited issue.

Corporate Governance

FIO Recommendation: States should develop corporate governance principles that impose character and fitness expectations on directors and officers appropriate to the size and complexity of the insurer.

The FIO report notes that while state regulators have the authority to conduct fitness reviews of insurer directors and officers, there is no NAIC model law on the subject. This fact has been noted by international authorities in their assessment of the U.S. system of insurance regulation. The report suggests that the focus on corporate governance that has taken place since the financial crisis "should continue and become more defined." It suggests that state regulators should adopt director and officer qualification standards that require individuals to have the expertise to assess strategies for growth and risks to the enterprise. For an insurer that exceeds size and complexity thresholds, the report recommends that state regulators adopt an approach designed to ensure that individuals serving in leadership ranks have sufficient capacity to understand and challenge an insurer's enterprise risk management.

The standards that FIO recommends for directors and officers may be instructional but should not be required. The specific skills identified may serve a purpose on a board, but diversity on the board is also a value. Mutual insurers serving specific occupational groups or types of businesses often have directors who are part of those specific groups and possess understanding and expertise about the needs of unique customers.

Also, corporate governance in the U.S. varies from state to state and is enforced and regulated by state agencies other than departments of insurance. This varied framework and the domicile choices made by insurers are part of the business model of each insurer. Changing that framework to satisfy international demands when no specific problem in the U.S has been identified may result in unreasonable costs and unintended consequences.

Finally, insurance regulators have numerous tools to identify, assess, and correct deficiencies in corporate governance. Insurance regulators in the U.S. have broad

authority under the model regulation related to companies deemed to be in hazardous financial condition to require correction of any corporate governance deficiencies. Before suggesting significant changes to corporate governance without an identified problem we believe existing tools should be implemented and allowed to work.

Group Supervision

FIO Recommendation: (1) In the absence of direct federal authority over an insurance group holding company, states should continue to develop approaches to group supervision and address the shortcomings of solo entity supervision; (2) State regulators should build toward effective group supervision by continued attention to supervisory colleges; and (3) The FIO should engage in supervisory colleges to monitor financial stability and identify issues or gaps in the regulation of large nationally and internationally active insurers.

The report raises concerns with the ability of any single-state regulatory authority to collect information or supervise the operations of a multi-jurisdictional insurance group, such as a large, complex global insurance firm. FIO believes that for such entities a consolidated group supervisor with knowledge of an insurer's enterprise risk management and intra-company transactions would provide superior supervision. To address these concerns, the FIO recommends improvements to the state-based regulatory structure to facilitate consolidated group supervision and expanded use of supervisory colleges. The recommendations of the FIO are similar to previous recommendations by the International Monetary Fund.

While recommending the expanded use of supervisory colleges, the report asserts that "consolidated supervision for large, internationally active U.S.-based insurance firms will require continued focus and national attention." The assertion leaves open the door to proposals for increased federal regulation of large, complex insurance operations. As part of a possibly expanded government role, the FIO recommends its participation in supervisory colleges established for U.S. firms operating nationally and internationally, and for non-U.S. firms with large operations in the United States.

The question of FIO's participation in supervisory colleges was raised during the December 14, 2013, E.U.-U.S. dialogue held in conjunction with the fall NAIC meeting. Concerns were raised by participants of the dialogue about the participation of a non-regulator in the actual operation of the supervisory college. FIO's active participation in supervisory colleges, as a non-regulatory entity, could be seen as a significant expansion of the authority of the office and raises the specter of regulatory intrusion.

The NAIC addressed group supervision by adopting revisions to the Model Holding Company Act in 2010.The revisions have been enacted in 24 states and have been proposed by nine more states to date in 2014. As a result of these enactments, the group supervision process has been dramatically altered and several international supervisory colleges have already met. NAMIC supports the changes to the Holding

Company Act to improve group supervision for large groups but asserts that a proportional approach to these requirements is needed.

Guaranty Funds

FIO Recommendation: States should adopt and implement uniform policyholder recovery rules so that policyholders, irrespective of where they reside, receive the same maximum benefits from guaranty funds.

The report notes that for property/casualty claims maximum guaranty fund payouts per claim are generally set by statute between $100,000 and $500,000, with most state laws using a $300,000 cap. As a result, consumers who purchase the same coverage or product from the same company may receive a different guaranty fund benefit depending on where they reside.

The report calls on the states to harmonize recovery rules to ensure that all policyholders, irrespective of where they reside, receive the same guaranty fund protection. The FIO suggests that if states fail to achieve uniformity, federal involvement may be necessary to ensure fair treatment of all policyholders.

It is unclear whether the FIO contemplates establishment of a federal-level guaranty fund system or establishment of a federal standard administered by the state-based guaranty fund system. The NAIC model guaranty fund language includes a $500,000 coverage cap, and recovery rules vary from state to state. Consequently, several states will require revision in their guaranty fund laws to meet the FIO call for uniformity. Adoption of uniform guaranty fund protection in all states would be preferred, but it would take some time. It is not clear how long the FIO would give states to adopt the changes before "federal involvement" would be attempted. NAMIC has long argued that subjecting insurance companies to a federal resolution authority would disrupt the existing well-functioning system. Replacing the state-based guaranty fund system with a federal system would likely be much less efficient in resolving claims inherently dependent on state law.

Producer Licensing

FIO Recommendation: The National Association of Registered Agents and Brokers Reform Act of 2013 should be adopted and its implementation monitored by the FIO.

Despite decades of attention and effort, the report cites continuing inconsistencies and inefficiencies resulting from the absence of uniformity in state producer licensing. The inability to achieve sufficient uniformity, the FIO argues, warrants congressional intervention. It recommends adoption of the National Association of Registered Agents and Brokers Reform Act of 2013 (NARAB-II) (H.R.1155/S. 534) that was overwhelmingly approved by the House and is pending approval in the Senate.

NAMIC supports passage of NARAB-II as a means to enhance competition in the marketplace, which will benefit insurance consumers while maintaining state authority to regulate the market and protect consumers.

Product Approval

FIO Recommendation: State-based insurance product approval processes should be improved by securing the participation of every state in the Interstate Insurance Product Regulation Commission (IIPRC) and by expanding the products subject to approval by the IIPRC. State regulators should pursue the development of nationally standardized forms and terms, or an interstate compact, to further streamline and improve the regulation of commercial lines.

The report notes that the absence of a uniform national standard for product approval has been criticized by both insurers and consumer advocates. Insurers point to the inefficiencies in the system and lament that the lack of uniformity compromises nationwide product availability. Consumers argue that disparate state standards and processes create opportunities for regulatory arbitrage. To address these concerns, the report recommends that states take immediate action to ensure that non-participating states join the IIPRC or adopt the standards and processes as a model law or regulation. It recommends that IIPRC standards should serve as a baseline while allowing states with higher consumer protection standards to continue enforcing those higher standards. It says that state regulators from member states should prohibit insurers from opting into less restrictive non-IIPRC standards and the scope of IIPRC's product coverage should be expanded. The FIO warned that "Federal action may become necessary if the current, and long-standing, shortcomings are not improved in the near term."

NAMIC believes that swift and efficient product review and approval are necessary to promote innovation to benefit consumers. Individual states from time to time launch initiatives to streamline processes and reduce backlogs, but inconsistencies remain. However, the experience of the compact for life and other non-property/casualty lines provides grounds to question whether that approach represents the best way to proceed. Regarding commercial lines in particular, NAMIC believes that gains have been achieved as noted in the FIO report through enactment of exempt commercial policyholder statutes but that more states need to pass such laws in order to achieve potential gains in this area. NAMIC is working with the NAIC's Commercial Lines Working Group to achieve that goal.

Market Conduct Regulation

FIO Recommendation: States should reform market conduct examination and oversight practices and: (1) Require state regulators to perform market conduct examinations consistent with the NAIC Market Regulation Handbook; (2) Seek information from other regulators before issuing a request to an insurer; (3) Develop standards and protocols

for contract market conduct examiners; and (4) Develop a list of approved contract examiners based on objective qualification standards.

The report makes a number of specific recommendations to improve market conduct regulation. Persistent problems in uniformity and efficiency in market conduct regulation led NAMIC to recommend to the FIO that standards might be included in an accreditation program, similar to the successful program on the financial side. However, because of unwillingness to recognize domestic deference in market regulation, there has been little progress toward development of binding standards for regulators for market conduct surveillance. Specifically, NAMIC suggested improvements to (1) reduce or eliminate regulatory redundancies; (2) increase interstate collaboration and cooperation among regulators; (3) ensure deference to the domestic regulator in market conduct matters; (4) implement systematic procedures for adding or changing market analysis tools or procedures; and (5) increase oversight and training of, and accountability by, contract examiners.

The report agreed with NAMIC that "coordination between states and standardization of market analysis, investigations and examinations are essential to modernization." Many of the recommendations contained in the report echo the themes and recommendations of NAMIC. Specifically, the FIO recommends that states should (1) develop a requirement that market conduct regulation be performed according to the handbook; (2) implement a process whereby information relevant to the same or similar statutory and regulatory requirements first be sought from another regulator before issuing a duplicative request to the insurer; (3) adhere to a "lead state" concept for multi-state market conduct examinations; (4) develop explicit standards and protocols to govern contract examiners including cost and schedule, education, professional background, training requirements, and appropriate ethical standards regarding conflict of interest, confidentiality, privacy, and report drafting; and (5) develop a list of approved contract examiners based on an objective evaluation of expertise and training to examine specific issues or industry participants.

The problems in market regulation are long- and well-recognized by the industry and regulatory communities, and the FIO report does a good job of laying them out along with the goals to remedy the problems. What it does not include is specific concrete policy measures to achieve those goals. The listing of problems in the report could serve as an impetus for more earnest action at the NAIC to address the problems.

Rate Regulation

FIO Recommendation: States should monitor the impact of different rate regulation regimes on various markets in order to identify rate-related regulatory practices that best foster competitive markets for personal lines insurance consumers. The FIO will work with state regulators to establish pilot programs for rate regulation that seek to maximize the number of insurers offering such products.

The report acknowledges empirical studies suggesting that rate regulation creates market distortions that adversely impact the supply of insurance and harm consumers. While the report does not call for an immediate move to open rate regulation in all states for all products, it does recommend a series of pilot projects to test rate reform. The FIO encourages states pursuing enhanced competition and capacity in personal lines insurance markets to try reforms on a limited or pilot basis to test the view that the burdens of rate regulation deter competition and reduce market capacity. The FIO noted it will continue to monitor developments in the area of rate regulation and "work with state regulators to identify best practices for implementation of pilot programs, as well as best practices for monitoring the impact of any change on consumer access to insurance."

Rate modernization has been a key component of NAMIC's regulatory agenda at the federal and state levels for many years. In comments to the FIO, NAMIC stressed the importance of removing barriers that limit property/casualty insurers' ability to set prices for insurance products. NAMIC is encouraged by the report's call for rate regulation innovation and stands ready work with states, the FIO, and the NAIC to identify test markets and product lines and initiate rate regulation reduction pilot programs as swiftly as possible. NAMIC is confident that, if structured appropriately to allow the development of competition, the results of the pilot programs will be consistent with academic studies illustrating the benefits of moving toward more open rating regimes. In fact, such studies suggest that the pilot projects are probably not necessary given that the state-based system of insurance regulation has provided a laboratory for testing a variety of different approaches to rate regulation for decades. As the report acknowledges, an abundance of existing evidence suggests that strict forms of rate regulation have a number of deleterious effects on personal lines insurance markets while providing few, if any, benefits.

Risk Classification

FIO Recommendation: (1) States should develop standards for the appropriate use of data for the pricing of personal lines insurance; (2) States should extend regulatory oversight to vendors that provide insurance score products to insurers; and (3) The FIO will study and report on the manner in which personal information is used for insurance pricing and coverage purposes.

As with rate regulation, NAMIC stressed to the FIO the importance of underwriting freedom and urged regulators and policymakers to not inhibit insurers' use of underwriting variables and techniques. With the development of enhanced information systems, such as automobile telematics, it is critically important that insurers be free to continue to develop and refine underwriting tools to more accurately reflect the risk of loss in the price of the product.

FIO Director McRaith has long been skeptical of the use of credit-based insurance scores, and the report reflects his concern. The report recommends that the criteria and methodologies used by insurers be clarified to ensure they do not rely on impermissible

or discriminatory risk factors. In a bid for a federal regulatory role, the report notes that "risk classification factors may be an appropriate subject for binding, uniform federal standards, particularly to the extent that insurance scoring methodologies involve factors that implicate rights secured under federal law." In addition to regulating the factors themselves, the report calls for more extensive oversight of insurance score vendors and companies that develop their own protocols. Specifically, it was recommended that state regulators make it a priority to improve regulatory oversight of vendors, including the development of a model law that would subject insurance score vendors to licensing and examination standards.

The report reflects McRaith's desire to elevate this issue to the federal level. The FIO cautioned state regulators and lawmakers that the office would push for federal involvement if reasonable progress is not achieved in the near term. In addition, the FIO noted it will study "the appropriate boundaries of use of personal information for insurance pricing and coverage purposes" as part of its ongoing responsibility to monitor access to affordable insurance to traditionally underserved communities.

While the report describes the use of credit-based insurance scores as "controversial," in NAMIC's view the controversy has been largely resolved. Insurance scoring has been studied extensively and has consistently been found to be a valid underwriting tool. Given that the report cites published empirical research on the effects of rate regulation, it is odd that the report's discussion of insurance scoring makes no mention of the many empirical studies, such as those conducted by the Federal Trade Commission and the Texas Department of Insurance, that provide incontrovertible evidence of the relationship between credit scores and insurance risk. References to these studies are conspicuously absent from the report's discussion of insurance scoring. Of course, there will always be some who will continue to question and challenge the practice, and the FIO report reflects that. NAMIC would dispute the suggestion that increased regulatory attention and activity are warranted in this area.

There is a notable inconsistency between the report's discussion of rate regulation and its discussion of risk classification. On the one hand, the report acknowledges that risk classification and rate-setting are closely related; it implicitly recognizes that an insurer cannot develop an actuarial (i.e., risk-based) rate if it cannot accurately assess and classify risk. Yet while the report cites empirical research showing that regulation of rates tends to distort personal lines insurance markets, its suggestion that federal restrictions be imposed on certain risk classification factors does not recognize the possibility that such restrictions will have roughly the same effect as rate regulation on insurance markets.

Finally, although raising the specter of "binding, uniform federal standards" is probably meant to suggest that the FIO could recommend that Congress enact legislation restricting the use of certain risk classification variables, the report's discussion of prospective federal standards serves nevertheless as a reminder of the need to ensure that the authority of the office itself is not expanded to a include a regulatory role.

Natural Catastrophes

FIO Recommendation: States should identify, adopt, and implement best practices to mitigate losses from natural catastrophes.

Although issues related to natural catastrophes were not raised in the request for comments, NAMIC nevertheless included them in its comments based on a belief that they are of such importance that no evaluation of insurance modernization would be complete without addressing their impact and addressing better ways for stakeholders to respond. In comments to the FIO, NAMIC outlined four core principles to guide the debate:

- Market freedom and competitive pricing will lead to innovation in developing solutions to problems relating to disaster insurance and mitigation;
- Competitive pricing and risk-based underwriting are essential to developing and maintaining a viable disaster insurance market;
- Mitigation must be an indispensable aspect of any disaster risk management and insurance initiative; and
- The National Flood Insurance Program should be maintained but must be reformed.

NAMIC also stressed the importance of strong and enforceable building codes.

With respect to other natural-catastrophe-related issues, the report notes that states are engaging in a variety of new and innovative approaches. As such, the FIO recommends that adoption of national policies wait until further development and evaluation of these programs. With respect to the National Flood Insurance Program, the report notes that a more detailed response will be provided in the upcoming report required by the Biggert-Waters National Flood Insurance Reform Act of 2012.

NAMIC is pleased that the FIO highlighted this issue for special consideration. We find it encouraging that the FIO report expounds at length on the importance of building codes and recommends that states "identify, adopt, and implement best practices for construction standards, including building codes, to mitigate losses from natural catastrophes."

Conclusion – Future Focus of FIO and Congress

On the whole, NAMIC believes the current U.S. state-based insurance regulatory system is robust and well-positioned to meet the needs of the nation's insurance marketplace. This does not mean that it is perfect. There are certainly areas that need improvement and NAMIC will continue advocating for positive changes.

With the release of the report, many have been asking which actions can or should be taken by FIO and Congress in the short-term that will help ensure the best, most effective regulatory system for U.S. insurers. NAMIC believes that FIO's focus should remain firmly on the myriad actions and initiatives at the international level and special care be taken to be involved and to protect against any unintended and tangential consequences that may arise therefrom.

It is our position that cooperation and coordination internationally is a positive thing, but it should not result in abdication of regulatory authority to foreign jurisdictions or quasi-governmental bodies. Too much focus on regulatory equivalence with other nations could result in significant and costly changes in the U.S. insurance regulatory system. Our system is strong and time-tested. Many of the international insurance regulatory principles have never been implemented, and yet they are being used to measure countries and find them insufficient. If these concerns are not properly addressed, the impact on not only U.S.-based international insurers, but also on those operating only domestically could be very significant and multi-faceted.

In the international realm, we urge FIO to coordinate with state regulators and legislators to advocate for international standards that are largely consistent with sound U.S. insurance regulatory approaches; that add value for the policyholders; and that, at a minimum, do not create competitive disadvantages for U.S.-based insurers, especially U.S. mutual insurance companies. In particular, FIO should operate from the premise that attempts by foreign entities to establish regulatory hegemony over the world's insurance markets will not necessarily serve the interests of insurers and consumers in the U.S.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

SUBCOMITTEE ON HOUSING AND INSURANCE

OF THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

ON

THE FEDERAL INSURANCE OFFICE'S REPORT ON MODERNIZING INSURANCE REGULATION

February 4, 2014

Statement Made by
Gary E. Hughes
Executive Vice President & General Counsel
American Council of Life Insurers

Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee, my name is Gary Hughes, and I am Executive Vice President and General Counsel of the American Council of Life Insurers ("ACLI"). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. These companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums.

ACLI appreciates the opportunity to provide you with its views on the report of the Federal Insurance Office ("FIO") entitled, *"How to Modernize and Improve the System of Insurance Regulation in the United States."* We believe the report presents a generally fair and balanced picture of the present state-based insurance regulatory system and the challenges it faces. In addition to serving as a comprehensive outline of insurance regulation in the U.S., the report highlights a number of issues that are of importance to the ACLI and its member companies, particularly those issues dealing with emerging capital standards in the U.S. and abroad.

Regulatory Change Affecting Life Insurance Companies

The focus of our testimony today is on regulatory change affecting the life insurance industry, the challenges this change presents to insurance companies and the role of the FIO in this context. During the pendency of the Dodd-Frank Act, ACLI advocated for the creation of the FIO. As regulatory initiatives unfold both here and abroad, we believe more strongly than ever that a unified, effective federal voice – working collaboratively with state insurance regulators – is essential to ensure that the U.S. insurance regulatory structure is one that is effective, fair and fosters a healthy and vibrant U.S. insurance marketplace for all companies regardless of corporate form or ownership structure.

Life insurance regulation is experiencing unprecedented and rapid change. The Dodd-Frank Act resulted in the Federal Reserve Board assuming a significant regulatory role with respect to those life insurers that are designated as systemically important as well as those controlling thrifts. At the same time, the Financial Stability Board ("FSB") is pressing the International Association of Insurance Supervisors ("IAIS") to impose group capital and supervisory standards on internationally active life insurance groups. Taken together, these initiatives directly affect approximately 60% of the direct premiums of ACLI member life insurance companies. Put differently, in the very near term a large segment of the life insurance industry will have aspects of its capital structure either dictated or materially influenced by entities other than state insurance regulators.

Add to this the fact that the European Union ("EU") is scheduled to implement its own modernization of insurance capital standards through Solvency II. And of course the states are contemplating how best to respond to these pressures from at home and abroad. Simply put, life insurance regulation in the U.S. can no longer be viewed as a purely domestic matter. If the capital standards developed by the states, the Federal Reserve, the IAIS and the EU are not generally consistent, the resulting competitive disparities will disrupt the U.S. and global life insurance marketplace and present significant opportunity for regulatory arbitrage.

Our perspective on the future of insurance regulation and on the importance of working constructively with the IAIS and other international standard-setting bodies may be somewhat unique among those testifying today, but understanding the diversity of our membership will illustrate why we believe this is critical and why we believe the FIO, as outlined in its report, has an important role to play in this regard. Two of our member companies have been designated as Systemically Important Financial Institutions ("SIFIs"). One additional company is under review for possible designation. Twelve of our member life insurers own thrifts and, like SIFIs, will be subject to whatever prudential standards the Federal Reserve decides to impose. At a minimum, we believe eighteen of our member companies are Internationally Active Insurance Groups (three of whom have been designated as Global Systemically Important Insurers) and at some point may be subject to the group capital and group supervision standards developed by the IAIS with direction from the FSB. Fifty-five of our member companies with major operations in the U.S. and representing 22% of total U.S. assets have foreign parents and consequently must also comply with the capital and supervisory requirements of their home countries. We also have a number of large and small member companies that do not fall into any of these categories but are legitimately concerned that whatever standards are developed and applied to the above companies may eventually migrate to them.

As an industry that until very recently had its core solvency standards set and administered exclusively by the states, post Dodd-Frank we have experienced a general lack of understanding of our industry by federal regulators and policymakers now involved in our business. This lack of understanding is most evident with respect to the unique characteristics of a life insurers' financial structure and the tools state insurance regulators employ to assure company solvency (e.g., insurance statutory accounting versus GAAP accounting). While the Federal Reserve and other federal regulatory bodies continue efforts to enhance their understanding of the more technical underpinnings of our business, the knowledge gap remains a significant impediment to dealing effectively with issues such the appropriate calibration of new capital standards. All too often, federal regulators tend to view these issues through the lens of those with whom they are most familiar - - commercial banks. As we have pointed out repeatedly, one cannot appropriately apply bank capital standards to a life insurance company. To do so would substantially and unnecessarily disrupt

insurers' fundamental business model, including the products they make available to provide consumers with life and longevity protection and retirement security.

We believe the FIO will be invaluable in helping fill the life insurance knowledge gap in Washington given the fact that a fundamental part of the office's statutory mission is to be the federal repository of information on insurance regulation. Over time, the FIO will be a more and more valuable resource for other federal regulatory agencies that now have some interest or responsibility with respect to the insurance industry and its regulation. The office will also be well positioned to interact with the NAIC, the states, the FSB, the IAIS, the EU and other international standard-setting bodies as global capital and supervisory standards evolve. And that evolution must occur on a rational and consistent basis in order to avoid major disruption and competitive inequities in the U.S and global markets. That will not happen absent strong advocacy by the FIO, the states and the industry working in concert and toward common objectives.

The states and the current insurance regulatory system served the industry well during the recent financial crisis. Indeed, insurers fared better than most other segments of financial services. That fact alone, however, does not lead to the conclusion that it is in the best interests of state insurance regulators and the U.S. insurance industry to simply stand pat and oppose federal and international initiatives to change the current insurance regulatory system. It would certainly be desirable if the rest of the world coalesced around the U.S. insurance regulatory model. But in light of Dodd-Frank and ongoing global regulatory initiatives, significant change to our insurance regulatory system is inevitable. Today's reality is that mere defense of the status quo is no longer a viable option. We look forward to the FIO being a constructive part of the global dialogue on insurance regulation, and we strongly encourage the FIO to coordinate closely with state insurance regulators as this process moves forward.

Federal Reserve Holding Company Capital Requirements

One aspect of evolving capital standards is of immediate concern to life insurers. As this Subcommittee is aware and as noted above, a number of life insurers are facing the application of holding company capital standards by the Federal Reserve due to their status as depository institution holding companies or designation as non-bank SIFIs. It is imperative that any holding company capital requirements applied to a life insurance enterprise be based on life insurer business models and life insurer risk-based capital principles, and not on a capital regime developed for and appropriate to commercial banks.

As we have noted repeatedly to Congress and various federal agencies, the life insurance business is fundamentally different then the banking business. Life insurance companies have significantly different

business and risk profiles and capital structures than those of banks. Life insurers provide coverage to customers for their long-term risks, and their regulation requires them to match those long-term, illiquid liabilities with appropriate assets to ensure that those liabilities can be met. Current life insurer capital requirements directly reflect the level to which an insurer has matched the duration of its assets to the duration of its liabilities. This business model is fundamentally different than that of banks, where assets and liabilities are not matched and where the institutions are more dependent on short-term, on-demand funding, and are thus potentially subject to a "run" in periods of stress. Banking capital requirements implicitly assume this inherent mismatch.

The business models, risk profiles and capital structures of life insurers and banks are so divergent that it would be incongruous to attempt the application of a single, one-size-fits-all capital standard to both. Unfortunately that is the scenario we continue to face due the Federal Reserve's interpretation of certain provisions of the Dodd-Frank Act. The issue here is not whether these particular life insurance companies oppose being subject to enhanced prudential standards. They have accepted the fact that they will be. The issue is whether it makes any sense whatsoever to impose ill-fitting, unsuitable capital standards to these enterprises and in so doing disrupt their business. The whole purpose of these provisions of the Dodd-Frank Act is to stabilize the U.S. financial system. Disrupting the operations of well-run life insurance companies is completely at odds with that purpose and should not under any circumstances be permitted to occur.

I would like to express our appreciation to Congressman Gary Miller and Congresswoman Carolyn McCarthy for introducing H.R. 2140, a bill that would amend the problematic provision of the Dodd-Frank Act and allow the Federal Reserve to develop and implement appropriate, insurance-centric capital standards for those life insurers under its jurisdiction. Similar legislation has been introduced in the Senate by your colleagues Senators Brown and Johanns, and we look forward to working with both houses of Congress on these important pieces of legislation.

Uniformity of Insurance Regulation

We fully agree with a central theme of the FIO report regarding the need for greater uniformity in state insurance regulation. Lack of uniformity was the primary impetus for the ACLI some 15 years ago to redouble its efforts to bring uniformity to the state system and embrace the concept of an optional federal charter. And as the report notes, Congress has entertained measures over the years to incent the states to regulate on a more uniform basis in areas such as market conduct, producer licensing, reinsurance and receivership. Of course, a regulatory construct with 56 separate jurisdictions presents inherent challenges in this regard. While the states have achieved a high degree of uniformity with respect to solvency standards

through the National Association of Insurance Commissioners ("NAIC") Financial Regulation Standards Accreditation Program, uniformity in other areas is still lacking. This leads to inefficiency and unnecessary costs that are ultimately passed along to consumers. ACLI remains open to congressional initiatives that would foster a more uniform and consequently more efficient system of insurance regulation.

NAIC Governance

We noted with interest the recommendation in the FIO report calling for "an independent, third-party review mechanism" to oversee the NAIC's financial accreditation program. The accreditation program is intended to provide uniform insurer solvency oversight in all jurisdictions and, as noted above, has largely achieved its desired goal. The program is one of a number of activities of the NAIC intended to make regulation more uniform between and among states, and to be clear, the industry has historically encouraged these initiatives in the interests of regulatory efficiency. However, as the number and importance of these programs has grown, it has become increasingly clear that some form of administrative due process and accountability is necessary. Certain standards in the NAIC's accreditation program essentially have the force and effect of law without any further meaningful action by the states, thus sidestepping otherwise applicable state administrative procedure statutes. No other state or federal body that functions in these capacities does so without predictable, formally stated and statutorily mandated administrative due process. The NAIC's role in the development of model laws and regulations that are in turn passed along to the states for implementation is not similarly problematic, since in those instances state administrative procedure acts will be triggered and will provide necessary due process and accountability.

This is not an easy matter to address given the unusual relationship between the NAIC, state insurance regulators and the insurance companies the states regulate. The NAIC is a membership organization comprised of state insurance commissioners. Insurance companies are not members of the NAIC nor do they have administrative rights with respect to the organization. But these companies are directly and significantly affected by decisions made by the NAIC in those instances in which the states have delegated responsibilities to the NAIC. ACLI has broached this concern with the NAIC and intends to work with the NAIC and the states to address the issue.

Captive Reinsurance Transactions

The FIO report discusses the issue of captive reinsurance transactions, and this is a matter of particular significance to life insurers. These arrangements are typically used to finance a portion of the statutory reserves companies are required to set aside when they issue term life insurance or universal life insurance with secondary guarantees. While we do not agree with some of the pejorative language in the report

describing these transactions and their operation, we do agree with the report's recommendations that captive reinsurance arrangements be subject to uniform standards to enhance transparency as well as uniform standards for evaluating the assets backing these arrangements.

For well over a year, the ACLI has been working with the states to address issues surrounding the regulation of captives. Last February we provided the NAIC with extensive suggestions for making captive transactions more transparent. We have also provided the NAIC with detailed suggestions for qualitative guidelines designed to enable regulators in all jurisdictions to evaluate proposed and ongoing captive arrangements on a consistent and uniform basis. In addition, we are currently working with the NAIC on the development of uniform quantitative standards that regulators can use to assure that captive reinsurers have assets that appropriately back both reserves and capital.

Captive reinsurance is an example of the challenges state insurance regulators are experiencing in today's environment. Not all states view captives and their regulation the same, and consequently there is not yet agreement among regulators regarding how the oversight of these arrangements should be handled. As the FIO report notes, it is often difficult to get multiple jurisdictions to agree on a common approach to regulatory issues. And while there is a clear consensus among life insurance companies on how the regulation of captives could be enhanced, there is not unanimity.

Unfortunately, slow movement on a final regulatory outcome on captives is giving rise to unprecedented scrutiny of these arrangements by a variety of nontraditional entities. In addition to the interest in captives expressed by the FIO, the following groups have involved themselves in the issue: the Federal Reserve; individual Federal Reserve banks; the Financial Stability Oversight Council; the Office of Financial Research, the Securities & Exchange Commission; the Federal Housing Finance Agency; and the FSB. In the final analysis, only the states have the statutory authority to address how the regulation of domestic captives will be addressed. But because we now exist in a global environment, the time it takes to resolve these types of issues becomes a much more important consideration. If regulators and standard setters other than the states perceive undue delay in addressing significant issues, they can now be expected to insert themselves into the details of how our business is regulated.

We are confident the states will take the steps necessary to improve the transparency and uniformity of the way in which capitve reinsurance transactions are regulated, and we encourage them to act as expeditiously as possible to bring this matter to an appropriate conclusion. We also encourage the FIO to be supportive of the states as this work moves forward.

Agent and Broker Licensing

Making the licensing process for insurance agents and brokers more efficient has long been a goal of the ACLI and its member companies. A particular concern has been the implementation of an efficient state system enabling agents and brokers to hold multi-state licenses. We applaud the House for passing H.R. 1155, the National Association of Registered Agents and Brokers Reform Act of 2013. This bill would provide a framework for uniformity and efficiency in agent and broker licensing requirements. A similar measure (S. 534) has passed the Senate Banking Committee, and we look forward to working with both houses of Congress to complete work on this initiative.

Reinsurance Collateral

The FIO report recommends that the Treasury Department and the United States Trade Representative pursue a bilateral or multilateral agreement among countries that the Dodd-Frank Act called a "covered agreement." Negotiating such an agreement with one or more countries could be the first step in a process to make state laws on reinsurance collateral more uniform. Such uniformity would be based on the framework and language unanimously endorsed by the NAIC. We support that recommendation. We also support the efforts of state insurance regulators, within the U.S.- EU Dialogue Project and under the FIO's leadership, to achieve a consistent approach within each jurisdiction and to examine further constructive improvements to each jurisdiction's treatment of reinsurance and reinsurers.

Conclusion

The FIO report is a balanced and thoughtful critique of the insurance regulatory framework, and we hope it serves as a catalyst for constructive discussion on how that framework can be improved. Given the rapid and unprecedented change under way with respect to how insurance will be regulated in the United States and around the globe, we continue to believe the FIO is well positioned to play a critical role in advocating for a regulatory structure that fosters a competitive and vibrant life insurance marketplace. We encourage the FIO to strengthen its relationship with the states to assure that emerging capital standards both here and abroad are firmly grounded in proven insurance-centric principles and treat all companies fairly regardless of their corporate or ownership structures. And we encourage the FIO in the strongest terms to work with the House and Senate to pass urgently needed legislation amending the Dodd-Frank Act to permit the Federal Reserve to impose insurance-oriented holding company standards on those life insurance enterprises under its jurisdiction.

Statement of Jon Jensen
On Behalf of the
Independent Insurance Agents and Brokers of America

Before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Housing and Insurance

At a Hearing Entitled:
"The Federal Insurance Office's
Report on Modernizing Insurance Regulation"

February 4, 2014

Introduction and Overview

The Independent Insurance Agents & Brokers of America, (IIABA or the Big "I"), is grateful for the opportunity to submit testimony to the U.S. House of Representatives Subcommittee on Insurance and Housing regarding the "Federal Insurance Office's Report on Modernizing Insurance Regulation." The Big "I" is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a nationwide network of more than a quarter million agents, brokers, and employees. IIABA represents independent insurance agents and brokers who present consumers with a choice of policy options from a variety of different insurance companies. These small, medium, and large businesses offer all lines of insurance – property/casualty, life, health, employee benefit plans, and retirement products. In fact, our members sell 80% of the commercial property/casualty market.

Over the last two years, the agent and broker community and other stakeholders in the insurance world have anxiously awaited the release of the Federal Insurance Office ("FIO")'s report on how insurance regulation in this country might be improved. FIO was charged with an unenviable assignment, and IIABA commends Director McRaith and his staff for producing a comprehensive, impressive, and largely balanced assessment of the insurance regulatory system. The extensive survey, which offers a detailed historical review of the industry in addition to its discussion of the current regulatory framework, is useful reading for anyone interested in the past, present, and future of insurance regulation.

The FIO report has generated well-deserved attention and analysis, and it is a thoughtful contribution to the enduring conversation and discourse concerning the future of insurance regulation. As with any report of this nature, interested parties and stakeholders have studied its findings and recommendations, carefully parsed its text, and have searched for particular passages that might be utilized to defend or advance their particular positions. This document provides an opportunity to reflect on the current state of insurance regulation and assess potential improvements.

The report contains over two dozen recommendations and identifies areas in need of reform, but nothing contained in the report causes IIABA to alter or question its fundamental and steadfast support for state insurance regulation. Our association has long supported state regulation of insurance, and the sensibility of that position has been reinforced and strengthened by the performance of that system in recent years. During a tumultuous period, state insurance regulators admirably and effectively ensured that insurers were solvent, that claims were paid, and that consumers were protected. State officials have decades of experience, outnumber their banking and securities counterparts, handle countless inquiries and questions from consumers, and understand the concerns and the often unique issues facing the citizens in their areas. State insurance regulation has a long and stable track record of accomplishment – especially in the areas of solvency regulation and consumer protection – and its benefits and merits have never been more apparent.

The recommendations offered in this report are, for the most part, modest in scope and suggest that the insurance regulatory system is functioning at a high level and does not require a significant overhaul or restructuring. IIABA agrees strongly with several of these recommendations (including FIO's call for the adoption of the much-discussed NARAB II producer licensing reform legislation) and is skeptical about others. Although my testimony addresses several of the specific recommendations contained in the report, we urge the members of this subcommittee and others not to focus too heavily or place too much emphasis on the itemized suggestions. While many of the individual recommendations are worthy of discussion and review, the more relevant and substantial elements of the report are the broader conclusions, observations, and themes that are identified. Let me highlight four such items:

- First, the report reminds us that insurance regulation, as with any system of regulatory oversight, is imperfect and can always be enhanced. State insurance regulation has a strong, successful, and unmatched record – especially in recent years – and has performed with particular distinction when compared with other financial sectors. The report serves as a reminder, however, that this successful system must continue to evolve and improve.

- Second, the report observes that the establishment of a full-blown federal regulatory framework or a dual state-federal system is not a prudent or viable option. Although some observers may have expected the Federal Insurance Office to have an institutional proclivity for such a recommendation, the report indicates instead that the debate over insurance

regulation should be reframed and focused on specific and targeted problems that may exist. Of course, the economic crisis highlighted and reinforced the pitfalls and serious deficiencies associated with creating an optional federal insurance regulatory system. When large financial services entities are permitted to select the regulator of their choice, they will select the path of least resistance and the system that best serves their business interests. That choice may not be – and is often not – what is in the best interest of the consumer, and our nation now has ample evidence of what can arise when regulatory arbitrage of this nature occurs.

- Third, the recommendations offered in the report are noticeably modest, and they affirm the relative health of state insurance regulation and indicate that sweeping and wholesale changes are unnecessary and unwarranted. The report recognizes that state officials have identified and are working to remedy certain flaws with the existing system, and many of the suggestions simply encourage states to continue their pursuit of existing efforts and note that FIO intends simply to monitor the progress of such work.

- Fourth, the report recommends the use of targeted and limited federal intervention to address problems that the states are unable to resolve on their own. The report notes that federal action of this kind should be limited to those instances where demonstrated deficiencies exist, where there is a national interest in addressing a particular problem, and where state officials are unable – as a result of practical hurdles or collective action challenges – to resolve the challenges themselves.

  The agent and broker community welcomes FIO's endorsement of this approach to reform. For more than a decade, IIABA has formally supported the use of targeted federal action to remedy and resolve clear flaws in the existing system without displacing or undermining the state-based framework. Limited federal legislation can effectively remedy identified deficiencies in the current system, establish greater interstate consistency in key areas, and preserve day-to-day regulation in the hands of state officials. This pragmatic and politically-feasible approach can be used on a compartmentalized issue-by-issue basis to address acknowledged problems and to establish uniformity and interstate consistency where necessary.

  Our experience in recent years suggests that there are certain problems with the state regulatory system that are resistant to reform via the traditional path of model laws and state-by-state legislative action. Targeted federal action can overcome the structural impediments, collective action challenges, and other practical and political barriers that have stalled previous reform efforts. There are a finite number of areas where uniformity and consistency are essential, and action can be taken to address these items without dismantling, replacing, or impairing the state-based system. State regulators do a tremendous job protecting consumers and ensuring the solvency of insurers, and nothing should be done to undermine or jeopardize their ability to do so on a prospective basis.

Topics of Interest

My remaining testimony focuses on the primary substantive topics discussed in sections of the report dedicated to marketplace issues and oversight.

Producer Licensing and NARAB II

The FIO report discusses the need for producer licensing reform at length, and this is the first subject discussed in the report's review of marketplace oversight issues. Director McRaith has been a strong supporter of reforming and simplifying the licensing process for producers since his days as the insurance regulator in Illinois, and we greatly acknowledge and appreciate the emphasis given to this issue in the report.

The report accurately describes the undue and unjustifiable burdens and costs that continue to exist in the licensing arena and notes, for example, that "inconsistencies and inefficiencies" and other problems persist despite the enactment of the original NARAB provisions as part of the Gramm-Leach-Bliley Act over 14 years ago. Many requirements encountered by multistate licensed producers are costly, burdensome and time consuming, and agents who operate in multiple jurisdictions face inconsistent standards and duplicative licensing processes. The report also addresses the impact on consumers and notes that inconsistent standards and duplicative licensing processes create "administrative and regulatory burdens without corresponding consumer benefit."

One of the problems today is that states too often ignore the principle of reciprocity and opt instead to reevaluate and second-guess the licensing decisions of a person's resident state, and the report accurately observes that many states that purport to have adopted the necessary reforms often fail to adhere to their own statutory requirements. Although the Gramm-Leach-Bliley Act and the state licensing laws clearly establish the limits of what may be required of a nonresident applicant – *a nonresident in good standing in his/her home state shall receive a license if the proper application or notice is submitted and the fees are paid* – some states continue to impose additional conditions and fail to respect the licensing determinations made by resident regulators. The imposition of these extra requirements (such as the submission of documents and other information that have already been provided to the home state regulator) makes it impossible for many insurance producers to quickly obtain and efficiently maintain the necessary licenses and violates the reciprocity standards established in federal and state law. In the words of the report, "[c]onsumers are detrimentally affected by the absence of uniformity and reciprocity."

Perhaps most notably, FIO proposes a specific solution to the challenges and problems that persist in the licensing arena – the enactment of the National Association of Registered Agents and Brokers Reform Act (or "NARAB II"). The NARAB II proposal would immediately establish the National Association of Registered Agents and Brokers ("NARAB") and provide agents and brokers with a long-awaited vehicle for obtaining the authority to operate on a multistate basis. It would eliminate barriers faced by agents who operate in multiple states, establish licensing reciprocity, and create a one-stop compliance mechanism. The bipartisan proposal benefits policyholders by increasing marketplace competition and consumer choice and by enabling insurance producers to more quickly and responsively serve the needs of consumers.

NARAB II ensures that any agent or broker who elects to become a member of NARAB will enjoy the benefits of true licensing reciprocity. In order to join NARAB, however, an insurance producer must be licensed in good standing in his/her home state, undergo a recent criminal

background check (long a priority of state insurance regulators), and satisfy the criteria established by NARAB. These criteria would include standards for personal qualifications, training, and experience, and – in order to discourage forum shopping and prevent a race to the bottom – the bill instructs the board to "consider the highest levels of insurance producer qualifications established under the licensing laws of the states."

NARAB's simple and limited mission would be to serve as a portal or central clearinghouse for insurance producers and agencies who seek the regulatory authority to operate in multiple states. The bill discretely utilizes targeted congressional action to produce efficiencies and is deferential to states' rights at the same time. NARAB II merely addresses marketplace entry and appropriately leaves regulatory authority in the hands of state officials.

The NARAB II proposal is a textbook example of how targeted action at the federal level can enhance and improve state insurance regulation. The proposal does nothing to limit or restrict the ability of state regulators to enforce state marketplace and consumer protection laws. State officials will continue to be responsible for regulating the conduct of producers and will, for example, investigate complaints and take enforcement and disciplinary action against any agent or broker who violates the law. In short, the NARAB II proposal would strengthen state insurance regulation, reduce unnecessary redundancies and regulatory costs, and enable the industry to more effectively serve the needs of insurance buyers – and it would achieve these results without displacing or adversely affecting state regulatory oversight.

IIABA is pleased that the NARAB II proposal continues its progress through the legislative process, and the agent and broker community is guardedly optimistic that this much-anticipated measure will be enacted into law in the near future. We greatly appreciate the Chairman and Representative David Scott's sponsorship of this bill and their leadership on this issue over the past several years. We thank the House for its overwhelming approval of this legislation last June when it passed by a vote of 397-6, and we are also pleased that the measure was approved by the Senate last week as part of its flood insurance bill. As the subcommittee and full committee craft flood insurance legislation for action by the House, we strongly urge you to include the NARAB II provisions in any proposal that is considered on the full floor.

Policy Form and Rate Regulation

The FIO report also discusses the need to improve the manner in which new insurance products are examined by regulators and introduced into the marketplace. IIABA agrees that action in this area is warranted and arguably overdue, and we support efforts that enable insurers and agents to be more responsive to the needs of consumers and commercial clients.

Insurance rates and policy forms are subject to some form of regulatory review in nearly every state, and the manner in which rates and forms are approved and regulated can differ dramatically from jurisdiction to jurisdiction and from one insurance line to the next. These requirements are significant because they not only affect the products and prices that can be implemented, but also the timing of product and rate changes in a competitive and dynamic marketplace. The current system is too often inefficient, paper-intensive, time-consuming, and duplicative, and changes and improvements are needed in order to encourage innovation and maximize consumer choice.

The report notes that product approval reforms are especially warranted in the commercial lines marketplace, and IIABA agrees while seeing differences between the need for product review of commercial forms versus personal forms. The paper notes that inconsistent and lengthy

approval processes limit the ability of the marketplace to meet the needs of business clients and drive many of these policyholders to surplus lines or self-insurance alternatives. States could improve the process by clearly articulating the standards that apply to the consideration of new policy forms and eliminate any so-called "desk drawer rules" that are not rooted in statute or properly promulgated regulations. The existing system could also be enhanced by requiring state regulators to complete their reviews of newly filed forms within a certain window of time, allowing forms to be deemed approved if no action is taken, and mandating that officials disclose the statutory or regulatory basis for any disapprovals of filings.

The report also addresses rate regulation and nudges states to consider alternative regulatory approaches that rely more heavily on competitive forces. The paper cites the empirical research that has found that rate regulation can often inadvertently result in fewer insurance carrier options, higher prices, and a larger market share for residual market mechanisms. States should instead rely on the forces of competition to establish insurance rates, eliminate the ability of regulators to establish prices, and continue to ensure that all insurance rates are neither discriminatory nor inadequate. This model for regulation has worked well in Illinois for years, and a growing number of other jurisdictions have started to examine and implement similar approaches.

Risk Classification

The FIO report also addresses the issue of risk classification and recommends that states develop standards governing the use of data in personal lines pricing.

IIABA supports the use of underwriting and rating tools that produce enhanced competition and the fair and accurate pricing of risk, and we recognize that consumer credit information and similar factors are powerfully predictive tools when used appropriately. The effectiveness of utilizing credit information has become increasingly apparent and widely accepted, even to those who were previously critical of its use, and agents can attest to the fact that it enables insurers to more accurately predict losses and the severity of future claims. The increased use of credit-based insurance scores has enhanced competition as companies have become more confident with the accuracy of their underwriting and rating tools, and, as a result, many agents are now able to find coverage (and prices) for clients in instances where such options were unavailable in the past.

At the same time, however, insurance scores must be used in sensible, responsible, and consumer-friendly ways – and IIABA has supported and helped implement a meaningful series of consumer protections at the state level. Most states have now enacted restrictions that limit when and how credit information and scores may be used in the insurance arena. These safeguards, for example, require additional underwriting factors to be taken into consideration when evaluating whether to underwrite, deny, cancel, or non-renew a policy; protect those with little or no credit history; impose helpful disclosure requirements; restrict the use of certain types of factors or credit information; and provide regulators with access to scoring methodologies and models.

The FIO report is vague about the types of standards that states might actually consider, but it is important to recognize that state officials have already been active in this arena. State policymakers in most jurisdictions have enacted comprehensive legislation that strikes the appropriate balance between the concerns of consumers and the needs of the marketplace. Insurance agents and brokers believe credit-based insurance scores are an effective,

objectively verified, and fair risk measurement tool, and IIABA opposes efforts to ban the use of this information or unnecessarily restrict its use.

Surplus Lines Regulation

The report also indicates that the Federal Insurance Office will continue to monitor state implementation of the Nonadmitted and Reinsurance Reform Act ("NRRA") provisions contained in the Dodd-Frank Act. The NRRA surplus lines reforms were supported by IIABA, and they offer another example of how targeted federal action can be utilized to improve insurance regulation without displacing, duplicating, or adversely affecting the existing state-based system.

The surplus lines reforms are designed to eliminate the unnecessary duplication and redundancy that historically existed in this arena by embracing a single state regulatory approach. The law requires jurisdictions to respect the requirements and conclusions of the insured's home state and specifically provides that "the placement of nonadmitted insurance shall be subject to the statutory and regulatory requirements solely of the insured's home state." The net effect of these provisions is that only the surplus lines licensing, diligent search, disclosure, and all similar placement requirements of the home state are to apply in any particular transaction. The law also includes a clear preemption provision stating that "any law, regulation, provision, or other action of any state that applies or purports to apply to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home state is another state shall be preempted with respect to such application."

The implementation of a single state-home state regulatory system and the enactment of other national surplus lines standards have been beneficial to many agents and brokers active in the nonadmitted insurance marketplace. IIABA remains concerned and vigilant, however, about the possibility of states circumventing the law and imposing state requirements that are inconsistent with the NRRA. Further action may indeed be warranted if states violate the clear and narrow mandates of this law.

Conclusion

The Big "I" appreciates today's hearing on "The Federal Insurance Office's Report on Modernizing Insurance Regulation." We thank the subcommittee for its efforts – past and present – to implement tangible and effective marketplace improvements, and we look forward to a continued discussion regarding the issues addressed in my testimony.

State of Connecticut

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Hartford

Chairman Neugebauer, Ranking Member Capuano, and members of the Committee, my name is Thomas Leonardi. I would first like to thank the committee for providing me with the opportunity to appear before you this morning. I know that you had a pool of 56 commissioners to choose from...the fact that you selected me is both an honor and a privilege which I greatly appreciate.

I would also be remiss if I did not take a brief moment to thank my boss, Dan Malloy, the Governor of the state of Connecticut:

- for his unfailing support for me and my department;
- for appointing me as his insurance commissioner, a job that has been the most demanding and rewarding in my 35 year career; and lastly
- for his vocal commitment to our national state-based system of insurance regulation.

Hartford CT has fondly been known as The Insurance Capital of the world for over two centuries. We regulate the largest life insurance industry in the country and the second largest when counting all insurance lines of business. In fact, CT would rank as one of the ten largest insurance regulatory authorities in the world if it were a separate country. The industry represents nearly 10% of the state's total Gross Domestic Product and is part of a huge financial services industry that employs more than one out of every five of our citizens. Clearly, Governor Malloy and the citizens of the state of Connecticut have a great interest in the issues before this committee today.

I also want to thank Senator Ben Nelson, the NAIC's CEO, for joining me – while I am here today to offer my views and those of the State of Connecticut, the FIO report impacts all of my fellow state regulators.

At the outset, I want to note that the Dodd-Frank Act did not task FIO to provide a broad and balanced evaluation of insurance regulation. Rather, it was specifically tasked with identifying areas where it believed improvement was needed. Nevertheless, the FIO report, much like last summer's GAO report and the Financial Stability Board's peer review, acknowledges that state regulators have developed an effective system of oversight that satisfies the most fundamental regulatory objective: ensuring insurance industry solvency and policyholder protection. We at the Connecticut Insurance Department pride ourselves on meeting this objective every day. But to retain this pride we must be constantly willing to improve and evolve to meet the next crisis or innovation.

The FIO report contains several recommendations for near-term reform by the states as well as a few suggestions for direct Federal involvement in regulation. As you might imagine, every year state regulators, legislators, and even Governors receive suggestions on various insurance regulatory issues from federal agencies, international bodies, the consumers we protect, and the industry we regulate. All suggestions on any given issue deserve serious and thoughtful consideration. In this case, state regulators are still in the process of evaluating the FIO report recommendations and will be meeting to discuss them later this month and in the months ahead. But I will offer a few initial observations.

It is worth noting that we are already addressing many of the items identified in the report. In particular, transitions to Principle Based Reserving and the Own Risk Solvency Assessment, strengthening of capital adequacy regimes, implementation of the Solvency Modernization Initiative, and discussions about improving our efforts on Corporate Governance and Marketplace Regulation are all ongoing. State regulation is not and has never been static. We have made significant enhancements to our system in the last few years, and the FIO report highlights several areas where that work continues.

There are other recommendations, however, that give me serious pause. For example, I oppose, and I believe most other state regulators are also opposed, to the idea that FIO should be allowed to participate in supervisory colleges. These are designed to be meetings of prudential regulators to share confidential, company-specific information. The presence of a non-regulator, even as well intentioned as Treasury, would threaten the objective independence of not just state regulators, but regulators at the federal and international levels who participate in the colleges, as well. Moreover, state regulators strongly disagree with FIO's call for the federal oversight of mortgage insurers. State regulators have the most experience and expertise to effectively regulate these insurers while also ensuring the availability of coverage in the market. A strong regulatory framework is already in place to monitor the activity of mortgage insurers, and efforts are underway to strengthen it. The financial crisis dramatically illustrated that simply federalizing regulation is no guaranty of better results. But if there are specific changes to our system that FIO would recommend, we are happy to consider those.

I appreciate FIO's efforts and all the work that went into the report. I look forward to working alongside my state regulator colleagues, as well as state legislators and Governors, as we consider these suggestions.

I would close by offering that the ultimate assessment of state regulation occurs not on paper but in the outcomes we provide to policyholders and the industry. State insurance regulators oversee the broadest, deepest, and most stable insurance market in the world, and those markets weathered the worst financial crisis in generations extremely well. And they remain stable, competitive, and a solid cornerstone of the US economy. Thank you again for the opportunity to be here today.

Thomas B. Leonardi
Commissioner
Connecticut Insurance Department

Testimony of Michael McRaith
Director of the Federal Insurance Office, U.S. Department of the Treasury
Hearing entitled "The Federal Insurance Office's Report on Modernizing Insurance Regulation"

House Financial Services Subcommittee on Housing and Insurance
February 4, 2014

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for inviting me to testify today on the Federal Insurance Office's report (Report) entitled "How To Modernize And Improve The System Of Insurance Regulation In The United States." The Report was released on December 12, 2013 and is available through the web site of the U.S. Department of the Treasury.

My name is Michael McRaith, and I am the Director of the Federal Insurance Office (FIO) in the U.S. Department of the Treasury.

The Report establishes a framework for the United States to build on the existing federal and state regulatory structure. While states generally perform consumer protection functions, many insurance regulatory issues of uniformity and national interest justify federal engagement. The insurance sector in the United States is both vast and essential, and long-standing prudential and marketplace issues may require a federal solution.

By any measure, insurance is a significant sector in the U.S. economy, providing not only essential asset protection tools for families and businesses, but also serving as a critical participant in the capital markets and financial service industries. In 2012, insurance premiums in the life and health (L/H) and property and casualty (P/C) insurance sectors totaled more than $1.1 trillion, or approximately 7% of gross domestic product. In the United States, insurers directly employ approximately 2.3 million people, or 1.7% of non-farm payrolls. More than 2.3 million licensed insurance agents and brokers hold more than 6 million licenses. Moreover, as of year-end 2012, the L/H and P/C sectors reported $7.3 trillion in total assets, $6.8 trillion of which were invested assets.

The penetration of the private insurance market is commonly measured as the ratio of premium to a nation's gross domestic product, a metric which demonstrates that developing economies provide fertile growth opportunities for U.S.-based insurers. By premium volume, the United States remains the world's largest insurance market: from 2008 to 2012, premium volume grew by $30.2 billion, but declined as a percentage of the U.S. gross domestic product (GDP) from 8.73% to 8.1%. At the same time, emerging and developed economies overseas have seen dramatic spikes in premium volume. From 2008 to 2012, China's premium volume, for example, increased by $105 billion, even though volume declined as a percentage of GDP (3.11% to 2.94%). Brazil's premium volume increased by nearly $35 billion and as a percentage of GDP (2.87% to 3.65%). South Korea's premium volume increased – by $42 billion – and as a percentage of GDP (2.27 to 3.02). With fast-paced international growth, insurance supervisors in countries around the world are pushing for improved consistency of supervisory standards to

understand better the operations, solvency, and risk management of firms operating in their markets. Improved consistency of supervisory standards will benefit U.S.-based insurers that operate globally.

Notwithstanding the role the federal government has had in some areas of insurance, through FIO, the United States now has an office that holds, among others, the authority to –

- monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system;
- monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products; and
- coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors and assisting the Secretary in negotiating covered agreements.

The states remain the primary regulators of individually licensed entities engaged in the business of insurance, but the federal government also has insurance oversight and supervisory responsibilities. The Federal Reserve Board (Board) serves as the consolidated supervisor of a savings and loan holding company that owns an insurer, and an insurer subject to Board supervision following designation by the Financial Stability Oversight Council (Council).

FIO Modernization Report

The Dodd-Frank Consumer Protection and Wall Street Reform Act directed FIO to, among other things, conduct a study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States. As required by statute, the Report is based on and guided by six explicit considerations and factors.

In developing the study, beginning in late 2011, FIO consulted extensively with interested parties from across the national and international insurance sector. FIO published a notice in the Federal Register on October 17, 2011, to solicit comments on the statutory factors and considerations. Nearly 150 written comments were provided in reply to that notice, all of which are available online at treasury.gov/initiatives/fio. Additional direct consultations occurred with nearly 40 different insurance sector stakeholders, including state insurance regulators, representatives of the industry and policyholders, advocates, and academics. On December 9, 2011, FIO hosted a conference at Treasury with representatives of the broad diversity within the insurance sector. Through 2012 and 2013, FIO continued to study the issues and consult with interested parties. The Report reflects many of the issues and topics raised by stakeholders throughout the consultation process, including through written comments, at the Treasury conference, and also through FIO's direct engagement with federal, state and international supervisors.

For purposes of the Report, FIO's analysis began with the predicate to address the world as it is, not as it was or as one might wish it were. Since President Theodore Roosevelt's annual message to Congress in 1904, the debate about reforming the U.S. system of insurance regulation

has foundered on the binary contentions that the business of insurance must be subject to either state or federal authority. That debate is a relic of a bygone era.

The federal government has played a role in insurance for years. In addition to market support programs like the Federal Crop Insurance Corporation and the Terrorism Risk Insurance Program, federal agencies like the Securities and Exchange Commission and the Federal Deposit Insurance Corporation have insurance responsibilities.

Further, the financial crisis illustrated the deficiencies in a state-based, solo entity approach to the supervision of insurance holding companies, and the potential threat to the national financial system of large, complex and internationally active financial firms. Thus, national and international financial stability initiatives, as well as the expanding international insurance marketplace, have driven regulatory change both in the United States and abroad. Indeed, although the states remain the primary regulators of individually licensed entities engaged in the business of insurance, the federal government now has explicit statutory roles insurance oversight and supervision (*e.g.*, Board supervision of insurance companies designated by the Council).

FIO Modernization Report – Analysis

FIO's Report determines that the U.S. should build on the existing hybrid model of insurance regulation, incorporating both federal and state oversight. The question is not whether federal involvement in insurance regulation is necessary, but where and how that involvement should be calibrated. A federal role in insurance regulation would improve uniformity of regulation, address the realities of globally active, diversified insurance firms, and better serve national interests.

The business of insurance is primarily regulated at the state level, and while proponents of the current system reasonably assert that the system works well, the absence of uniformity in the U.S. insurance regulatory system creates inefficiencies and burdens for consumers, U.S.-based insurers, and international market participants. This hybrid framework not only reflects today's reality, but also provides a foundation for Congress and other policymakers to address areas for improvement in the existing hybrid model of insurance regulation.

In particular, the Report identifies the following areas for modernization and improvement:

Areas of Near-Term Reform for the States

Capital Adequacy and Safety/Soundness

1) *For material solvency oversight decisions of a discretionary nature, states should develop and implement a process that obligates the appropriate state regulator to first obtain the consent of regulators from other states in which the subject insurer operates.*

2) *To improve consistency of solvency oversight, states should establish an independent, third-party review mechanism for the National Association of Insurance Commissioners Financial Regulation Standards Accreditation Program.*

3) *States should develop a uniform and transparent solvency oversight regime for the transfer of risk to reinsurance captives.*

4) *State-based solvency oversight and capital adequacy regimes should converge toward best practices and uniform standards.*

5) *States should move forward cautiously with the implementation of principles-based reserving and condition it upon: (1) the establishment of consistent, binding guidelines to govern regulatory practices that determine whether a domestic insurer complies with accounting and solvency requirements; and (2) attracting and retaining supervisory resources and developing uniform guidelines to monitor supervisory review of principles-based reserving.*

6) *States should develop corporate governance principles that impose character and fitness expectations on directors and officers appropriate to the size and complexity of the insurer.*

7) *In the absence of direct federal authority over an insurance group holding company, states should continue to develop approaches to group supervision and address the shortcomings of solo entity supervision.*

8) *State regulators should build toward effective group supervision by continued attention to supervisory colleges.*

<u>Reform of Insurer Resolution Practices</u>

9) *States should: (1) adopt a uniform approach to address the closing out and netting of qualified contracts with counterparties; and (2) develop requirements for transparent financial reporting regarding the administration of a receivership estate.*

10) *States should adopt and implement uniform policyholder recovery rules so that policyholders, irrespective of where they reside, receive the same maximum benefits from guaranty funds.*

<u>Marketplace Regulation</u>

11) *States should assess whether or in what manner marital status is an appropriate underwriting or rating consideration.*

12) *State-based insurance product approval processes should be improved by securing the participation of every state in the Interstate Insurance Product Regulation Commission (IIPRC) and by expanding the products subject to approval by the IIPRC. State regulators should pursue the development of nationally standardized forms and terms, or an interstate compact, to further streamline and improve the regulation of commercial lines.*

13) *In order to fairly protect consumers in all parts of the United States, every state should adopt and enforce the National Association of Insurance Commissioners Suitability in Annuities Transactions Model Regulation.*

14) *States should reform market conduct examination and oversight practices and: (1) require state regulators to perform market conduct examinations consistent with the National Association of Insurance Commissioners Market Regulation Handbook; (2) seek information from other regulators before issuing a request to an insurer; (3) develop standards and protocols for contract market conduct examiners; and (4) develop a list of approved contract examiners based on objective qualification standards.*

15) *States should monitor the impact of different rate regulation regimes on various markets in order to identify rate-related regulatory practices that best foster competitive markets for personal lines insurance consumers.*

16) *States should develop standards for the appropriate use of data for the pricing of personal lines insurance.*

17) *States should extend regulatory oversight to vendors that provide insurance score products to insurers.*

18) *States should identify, adopt, and implement best practices to mitigate losses from natural catastrophes.*

Areas for Direct Federal Involvement in Regulation

1) *Federal standards and oversight for mortgage insurers should be developed and implemented.*

2) *To afford nationally uniform treatment of reinsurers, FIO recommends that Treasury and the United States Trade Representative pursue a covered agreement for reinsurance collateral requirements based on the National Association of Insurance Commissioners Credit for Reinsurance Model Law and Regulation.*

3) *FIO should engage in supervisory colleges to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers.*

4) *The National Association of Registered Agents and Brokers Reform Act of 2013 should be adopted and its implementation monitored by FIO.*

5) *FIO will convene and work with federal agencies, state regulators and other interested parties to develop personal auto insurance policies for U.S. military personnel enforceable across state lines.*

6) *FIO will work with state regulators to establish pilot programs for rate regulation that seek to maximize the number of insurers offering personal lines products.*

7) *FIO will study and report on the manner in which personal information is used for insurance pricing and coverage purposes.*

8) *FIO will consult with Tribal leaders to identify alternatives to improve the accessibility and affordability of insurance on sovereign Native American and Tribal lands.*

9) *FIO will continue to monitor state progress on implementation of Subtitle B of Title V of the Dodd-Frank Act, which requires states to simplify the collection of surplus lines taxes, and determine whether federal action may be warranted in the near term.*

FIO Modernization Report – Conclusions

In short, the Report concludes that the states generally provide effective consumer protection. The ability of an insurer to pay a policy obligation is the bedrock of state solvency oversight. However, the Report also identifies issues for improvement that have received attention from the states, some for years. For example, state-based market conduct examinations and product approval processes have long been unduly burdensome, costly and redundant, but states have been unable to resolve these challenges with uniform practices. Another example is the proliferation of special purpose vehicles serving as life reinsurance captives, developments which have led to state-by-state variances and raises serious questions about the state-based solvency regime. Nevertheless, the states have not developed a consensus approach to resolving this issue and, as a result, are far from developing a uniform implementation approach. States have also failed to address—much less resolve—the use of data mining technology by insurers offering personal lines insurance products. These are a few examples of long-standing issues in need of a solution: the *status quo* will not resolve the problems of inefficiency, redundancy, or lack of uniformity.

As detailed in the Report, a number of recommendations call for direct federal involvement. For example, the financial crisis demonstrated the importance of the housing finance system to the U.S. national economy. Nevertheless, private mortgage insurers are subject to state regulatory regimes that differ in supervision and in levels of enforcement. Several private mortgage insurers failed or suffered potential financial distress, and the costs of default and foreclosure were shifted to lenders, the government-sponsored enterprises, and ultimately the taxpayer. The Report calls for federal supervision of the private mortgage industry, both in terms of standard-setting and the enforcement of those standards. Under this recommendation, however, it is conceived that a state would still be permitted to impose and retain premium taxes and would retain the authority to license and supervise the conduct of agents and brokers. While the federal government has an unambiguous leadership role in international standard-setting activities, other recommendations call for a direct FIO role in coordinating solutions to existing problems, such as personal auto policies for members of the armed forces, and pilot programs to decrease rate regulation in order to promote competitive markets. In the area of collateral required of non-U.S. reinsurers, the Report recommends the negotiation of an agreement to impose national uniformity in a global market.

The Report outlines FIO's ongoing work to modernize and improve the U.S. system of insurance regulation. Working with all aspects of the insurance sector, including federal supervisors, the

states, consumers, and industry, FIO will monitor and report publicly on progress made to effectuate the recommendations. FIO's Report is only one milestone –status reports will be forthcoming. Whether, and to what extent, necessary improvements will require federal involvement or Congressional action will depend upon the subject matter, circumstances, and ability and willingness of states to resolve the underlying issue. Finally, the Report provides a pragmatic, fact-based framework to move the United States forward and to preserve the U.S. global leadership position in the insurance sector.

Thank you, Chairman Neugebauer, for the invitation to discuss FIO's Report on how to modernize and improve the system of insurance regulation in the United States. I look forward to answering your questions.

REINSURANCE ASSOCIATION OF AMERICA

STATEMENT

TESTIMONY

OF

FRANKLIN W. NUTTER
PRESIDENT
REINSURANCE ASSOCIATION OF AMERICA

HOUSE SUBCOMMITTEE ON HOUSING AND INSURANCE

HEARING ON

"THE FEDERAL INSURANCE OFFICE'S REPORT ON MODERNIZING INSURANCE REGULATION"

February 4, 2014

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Mr. Chairman, members of the Committee, I am Franklin Nutter, President of the Reinsurance Association of America. Thank you for the opportunity to testify on the "Federal Insurance Office's Report on Modernizing Insurance Regulation."

The RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross border basis. RAA members consist of both U.S. and non-U.S. based companies with an interest in the regulatory environment in which they operate, including solvency and financial oversight and reporting, as well as market access.

The RAA supported the provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that authorizes the Federal Insurance Office, working with the U.S. Trade Representative (USTR) to enter into "covered agreements." This gives those governmental entities the authority, indeed we believe the mandate, to pursue "bilateral or multi-lateral agreements regarding prudential measures with respect to the business of insurance or reinsurance" between the U.S. and one or more foreign governments. These covered agreements will provide uniform regulatory criteria for transactions between U.S. and non-U.S. (re)insurers.

Insurance is widely regarded as facilitating economic activity as well as personal and commercial security. Reinsurance provides insurers with capital support, diversification of their risk profile, and risk transfer for extreme loss events. Covered agreements will facilitate the provision of global capital and risk taking capacity, and therefore will benefit economic activity and recovery in the U.S. as well as in the other countries.

We envision these covered agreements to provide the regulatory framework for U.S. (re)insurers in foreign countries and non-U.S. (re)insurers in the U.S. We do not see this as a new layer of regulation, but rather as a Federally authorized "tool" that would be applied within the context of the state regulatory system. As such, these agreements will ensure uniformity and efficiency for insurers and reinsurers within the structure of state-based solvency regulation in the U.S. and within the established regulatory systems in other countries.

We are pleased to see the Federal Insurance Office Report endorse the pursuit of covered agreements. The FIO report defines its interest in the context of financial security provided by unauthorized reinsurers based on the NAIC's recently-revised Model Law on Credit for Reinsurance. The RAA supports the recent NAIC model law revisions and has worked vigorously to secure their adoption by the states. (Since 2010 changes to the model have been adopted by 18 states.) Notwithstanding our active advocacy for the NAIC model, it is clear that it will take many years for these changes to be adopted by all of the states. Unfortunately, the changes to the model are not an NAIC accreditation requirement. Therefore the states are not required to adopt the changes to comply with the accreditation criteria. For the states that have adopted the changes, implementing regulations have been promulgated in 14 states; however only 6 have actually approved reinsurers. The NAIC model law process as applied to this new model law also assumes the states individually, based on an NAIC approved list of "qualified jurisdictions", will make a determination of the equivalence of a foreign country's reinsurance regulation. The RAA believes covered agreements, based on Federal statutory and constitutional authority, between the U.S. and countries or governmental bodies representing major (re)insurance trading partners provide the preferred approach for addressing the basis of

regulatory equivalence and appropriate regulatory security. Once achieved, these covered agreements will facilitate reinsurance transactions to support economic activity and recovery in the U.S. as well as in foreign countries.

It is clear that the statutory authority in Dodd-Frank does not limit covered agreements to matters related to collateral for unauthorized reinsurance. There are a host of prudential issues that could be addressed in a covered agreement that would strengthen existing regulation and enhance and streamline the basis upon which companies from one jurisdiction do business in the other's jurisdiction—including group supervision, data security and access, and international regulatory cooperation. We recognize the use of this authority beyond "collateral" may concern some interest groups. However, the statute requires a process of review by four Congressional committees, including this one, the likely involvement of the states with FIO and USTR in negotiating any such agreement and implementation within the state regulatory system, not a new Federal system. We believe these protections should allay those concerns.

We believe the European Union, under its Reinsurance Directive and Solvency II when implemented, has the authority to enter into covered agreements. Regulatory and trade officials in countries that host major reinsurance trading partners, including the U.K., Bermuda, Germany, France, Italy, Australia, Japan and Switzerland have all expressed interest in resolving the issue of cross border reinsurance relationships. As noted by the European Commission regarding the inclusion of insurance in a financial services trade agreement, the benefits of transatlantic integration are clear:

- strengthen financial stability, as potential problems would be jointly identified and addressed;
- create a larger and more efficient market place for EU and U.S. financial firms;
- improve the ability of the integrated financial system to provide financing to the real economy;
- solidify the leading role that the EU and the U.S. play in financial regulation.

All of these stated benefits could also be addressed in a covered agreement.

The U.S. is a major, attractive market for the global reinsurance industry. The U.S. is also the home jurisdiction for several major (re)insurers that operate on a global basis and provide financial security for worldwide insurance markets. A covered agreement should be tailored to be of mutual value to those interests.

We encourage the Committee to insist that USTR and Treasury move forward on the negotiation of one or more covered agreements. This Committee originated the idea and was right to do so. Now that Treasury has set its priorities in the FIO report, the Committee should expect it to pursue covered agreements. We look forward to working with USTR, FIO and the Congress to implement this valuable tool.

Testimony
Robert Restrepo
President, Chairman, and CEO
State Auto Insurance Companies
On behalf of
Property Casualty Insurers Association of America (PCI)

The Federal Insurance Office's Report on Modernizing Insurance Regulation

Subcommittee on Housing and Insurance
Committee on Financial Services
United States House of Representative
February 3, 2014

Thank you Mr. Chairman and Ranking Member for inviting PCI to testify today.

My name is Bob Restrepo, President, Chairman and CEO of State Auto Insurance Companies and Chairman of PCI. State Auto was founded in 1921 and today is an A rated insurer with 2,500 employees countrywide providing a broad range of protection to consumers for their home, auto and business needs. PCI is composed of more than 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write more than $195 billion in annual premium and 39 percent of the nation's property casualty insurance, epitomizing the diversity and strength of the U.S. and global insurance markets.

I am going to provide a different overview of the current insurance regulatory system from the FIO report. I will talk about some areas where PCI and State Auto agree with the report on the need for reform and some recommendations that might bear reconsideration. Then, I will end with some questions and thoughts about how Congress might want to follow-up.

Framing the Current Regulatory System and the Right Questions for Improvement

The U.S. has the largest and most diverse insurance market in the world, with a 150 year track record of comprehensive state regulation protecting consumers. The insurance sector has been stable throughout the last several financial crises, and despite a confluence in the last decade of record storms, market contractions and regulatory changes has had no major recent insolvencies, has achieved record levels of capitalization, and our residual markets for consumers and businesses are at or near historic lows suggesting that overall private sector insurance availability is better than ever for consumers. The more local focus of our state-based insurance regulatory system has allowed property and casualty insurance markets to be more responsive to the particular local needs and realities of insurance customers and the companies that serve them.

State regulation is, however, far from perfect. The FIO report does a good job of itemizing the numerous current controversies in insurance regulation that the states are working on. For example, while the states have clearly performed well in protecting consumers through solvency regulation they could do better in allowing open competition in rating without prior approval, coordinating market conduct exams, and streamlining commercial forms approvals.

But we would fundamentally disagree with FIO's conclusion that "The need for uniformity and the realities of globally active, diversified financial firms compel the conclusion that federal involvement of some kind in insurance regulation is necessary" or that a "hybrid" federal-state approach would be preferable. PCI previously provided to the Committee during the Dodd-Frank Act debates a statistical analysis comparing federally regulated banking and thrift insolvencies to insurance failures, and in fact state regulation compared quite favorably. Federal involvement is neither inherently uniform, as evidenced in the banking sector, nor have most foreign jurisdictions with federal regulation implemented more sophisticated consumer protections.

The better question is perhaps not whether federal involvement is necessary, but rather what are the best standards for good regulation and good regulators and where can the current system be improved. PCI's mission, which State Auto supports, is to promote and protect the viability of a competitive private insurance market for the benefit of consumers and insurers and we have analyzed each of FIO's recommendation through this filter.

FIO Recommendations that Could Improve the Market

State price controls on insurance rates including prior approval requirements pose a constant threat to the marketplace and are virtually unknown in other sophisticated insurance markets. Recent experience in New Jersey auto insurance and Florida property insurance are classic examples of how politicized rate regulatory systems can create market failures, artificial scarcities, less competition and higher prices over the long term. Academic and economic observers are almost unanimous in their criticism of rate regulation, yet it continues to be practiced in most states. Classic economic theory suggests that rate regulation should be reserved for oversight of monopolistic markets, but the insurance industry has very low market concentration with thousands of companies vigorously competing to offer consumers the best products and prices. FIO accurately cites studies finding that rate regulation reduces availability and affordability and cites the success in Director McRaith's home state of Illinois in allowing free-market private competition for consumers. PCI and State Auto agree with FIO's analysis on rate regulation and suggest promoting the model laws, for example, those of the National Conference of Insurance Legislators, to eliminate prior approval rate requirements.

Market conduct is another area where the states have made some improvements but, as FIO accurately reports, more progress is needed. States often pursue duplicative exams or investigations the benefits of which are unlikely to exceed the costs, sometimes using outside examiners with inconsistent quality and expense controls. While the NAIC has a group working on the issue, we would encourage them to provide a timeline for improvements similar to that followed vigorously for qualified jurisdictions under the NAIC's amendments to the Credit for Reinsurance Model Law. The NAIC could also set up a task force to develop standards and protocols for outside examiners.

Commercial lines regulation, especially product approval, should be modernized. Insurers should be able to respond more quickly to the needs of their commercial customers, especially those that are large and sophisticated. The inability to do so costs commonly regulated insurers billions annually in loss of business compared to less regulated alternative risk transfer mechanisms. We have provided the NAIC with a list of reforms and they are now surveying the states but more progress is needed in this area.

There are other recommendations of the report that we hope will encourage action, including pursuing further uniformity for surplus lines, Congressional enactment of NARAB II for insurance agent licensing, and improved loss mitigation to help reduce natural catastrophe risk.

FIO's Recommendations that Could Harm the Market

The FIO report makes several recommendations that do not meet PCI's test of promoting and protecting the viability of a competitive private insurance market for the benefit of consumers and insurers.

While FIO supports free market rates, the report suggests that federal standards may be appropriate for governing the risk factors that are used to set rates. In fact, every single state currently prohibits unfair discrimination by insurers and regulators are constantly studying and evolving their regulations with significant success in maximizing insurance availability and affordability while bringing last-resort residual markets to all-time lows. The few states that have experimented with limiting the ability of insurers to consider consumer risk factors other than for protected classes have not only impaired their markets but have limited the ability of consumers to take advantage of modern technology such as vehicle telematics, which can be used to price coverage based on individual driving behavior. Governments often seek to manipulate insurance markets for socially driven cross-subsidies, but we suggest that FIO could seek to encourage the states to reduce barriers to new rating technologies more quickly.

The report also makes a number of recommendations pressing state regulators to adopt best practices, standards, and principles that are developed by international bodies. PCI welcomes more international coordination, mutual recognition and, where appropriate, harmonization. However, we do not support the current push for a one-size-fits-all bank-like global regulatory system. The U.S. system is very focused on protecting insurance consumers and has had considerable success.

A number of international standards are developed based on a different mission or market structure than those applicable in the U.S., for example shifting focus to protecting investors or employers, or the need to set a higher bar against failures because of the absence of the safety net of guaranty funds. Imposing the same regulatory standards and trip wires on every country when the underlying regulatory missions and systems are fundamentally different is not always in the best interests of American consumers. Indeed, adopting a single global set of standards could even give rise to systemic risk that does not exist in the current environment of diverse business models. This Committee has previously encouraged the representatives of the state and federal government to work together and coordinate our insurance voice internationally. We believe that this goal is more important than ever.

Additional Considerations

PCI's board will shortly act on a more comprehensive and detailed response to each of the recommendations in the FIO report that we will provide to Congress, but a more fundamental question is, given the very limited resources of the FIO office and its carefully defined role under Dodd-Frank: what fundamental strategic purpose should it serve?

Assisting the Secretary in administering the Terrorism Risk Insurance Act (TRIA) is clearly a statutory priority. FIO is working on a separate report on TRIA and the terrorism insurance market as part of Treasury's involvement in the President's Working Group on Financial Markets, but is there additional guidance FIO can provide as TRIA reauthorization legislation is being considered by the Committee?

The Dodd-Frank Act directs FIO to consult with the States and coordinate Federal efforts on international prudential matters. With the expanding number of "voices" representing the U.S. in international regulatory discussions, are there additional opportunities for FIO to serve a coordinating role to bring together the NAIC and state regulators, state legislators, the Treasury, the Fed and the FSOC's independent insurance expert to hammer out joint positions? Can we get a united position for our marketplace or have we just added multiple federal voices to the multiple state voices? The failure to advocate a single U.S. message weakens our negotiating power in a highly competitive regulatory negotiating scrum with differing country interests.

FIO has done a good job at outreach to the industry on a number of issues. But the international regulatory discussions are increasingly going far beyond the parameters in the Dodd-Frank Act and are increasingly being held behind closed doors by non-U.S. and non-insurance actors without individual accountability for global policymaking. Are there opportunities for FIO to press for more transparency and public discussion of the Financial Stability Board and International Association of Insurance Supervisors where critical decisions are made without due process rights or legal protections, for example with respect to designations of systemically important insurers? And what involvement should Congress have in the U.S. involvement in setting new standards the NAIC is being pressured to adopt that go well beyond the Dodd-Frank Act?

Finally, are there opportunities for FIO to insist on more rigorous deliberation, including cost benefit analyses, in international standard setting discussions? Too often, we have seen costly new mandates emerge from closed door meetings with no proof that the additional compliance costs will be a net benefit for either insurers or consumers in terms of competition and cost. Instead there is often only a stated assumption that centralization of regulation is inherently good and regulators need to adopt global standards and then work out the details as they go along. Increasing regulatory costs are driving particularly smaller insurers out of business and worsening coverage availability and affordability for consumers.

Conclusion

The U.S. property and casualty insurance market is financially strong, competitive, characterized by diverse business models and comprehensively regulated. In this context, the FIO report's specific recommendations deserve serious consideration and should be judged according to their effects on the market. The states can certainly make improvements towards free-market pricing, better market conduct examination coordination and commercial streamlining, although hopefully not undermine the ability of the marketplace to use appropriate risk factors or impose suboptimal bank-like global standards where they do not benefit private competition for consumers and insurers. Ultimately, Congress and FIO will have to decide strategic priorities given limited available resources. We suggest promotion of free market pricing and coordination of U.S.-international policymaking should be key drivers. PCI and State Auto appreciate your interest and look forward to working with you and FIO in this endeavor.

THE COUNCIL

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Testimony of The Council of Insurance Agents & Brokers

House Financial Services Committee Subcommittee on Housing and Insurance
Hearing on The Federal Insurance Office's Report on Modernizing Insurance Regulation

February 4, 2014

Chairman Hensarling and members of the Committee, thank you for the opportunity to testify before you today. My name is Scott Sinder. I am the General Counsel of the Council of Insurance Agents & Brokers (The Council), and a partner at Steptoe & Johnson LLP. My testimony today is on behalf of The Council and its member firms.

The Council represents the nation's leading, most productive and most profitable commercial property and casualty insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, with nearly one in five members with presence outside the United States, Council members conduct business in more than 5,000 locations, employ well over 250,000 people, and annually place approximately 85 percent – well over $200 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

Thank you for inviting The Council to testify today with respect to the Federal Insurance Office (FIO) report on "How to Modernize and Improve the System of Insurance Regulation in the United States" (the Report) which was published in December 2013. Creating an effective and efficient insurance regulatory system in the United States is important not only to insurance brokers and the industry in general, but to consumers, policyholders and the economy as a whole. The FIO Report provides a roadmap for reaching that goal.

We believe the Report is authoritative and compelling. In the long history of the debate over federal versus state insurance regulation, the Report hits the right notes of balance. As the Report says, it is not so much the question of federal versus state authority, "but whether there are areas in which federal involvement in regulation under the state-based system is warranted." Like FIO, we believe there are areas where the federal government can and should be involved directly in insurance regulation, and areas where direct federal action may not be warranted, but federal pressure on the states could go a long way toward improving regulation at the state level.

The Council represents the agents and brokers who collectively sell the overwhelming majority of insurance products to American businesses. From a business insurance standpoint, there are a number of recommendations in the Report that, if implemented, would significantly impact – in a positive way – the ability of our members to operate and serve their clients, the insurance consumers who need coverage to operate their businesses. These recommendations include direct federal involvement in the international arena, as well as indirect federal involvement through standard-setting and the implementation of national standards and rules in insurance producer licensing and surplus lines insurance.

International – FIO's Recommendations for Direct Federal Involvement in IAIS and Trade Issues is Good for American Brokers and for American Businesses

In the category of "areas for direct federal involvement in regulation," we believe the case for a unified voice international insurance negotiations is persuasive and, in many respects, irrefutable. Coordination of international insurance regulatory policies is critical to insurance brokers,

insurance consumers, and to U.S. economic growth. The stakes are too high on the international regulatory environment for our industry to be represented in a confusing, disjointed, competitive way.

As the Report notes, "many aspects of the insurance sector are increasingly global and standard-setting activities will deeply affect oversight of the industry in both developed and emerging markets around the world. Moreover, inattention to global matters and discord among jurisdictions could lead to competitive disadvantages for U.S. firms." The U.S. insurance industry creates American jobs by exporting its products and services and by helping other U.S. industries take the risks they need to grow globally. Initiatives that open global insurance markets and create a level playing field will provide brokers the structural framework needed to allow them to service their clients wherever they operate around the world, thus benefitting the U.S. economy and job market, and, indeed, economies around the world. Much remains to be done, however, to reach these goals. That is why we were pleased that the NRRA empowered FIO in the international arena, establishing a single voice for the U.S. in international regulatory matters, and that FIO, in the Report and in its actions to date, has taken on this role with enthusiasm and assertiveness. FIO's international leadership role is a game changer, the importance of which cannot be overstated.

Until the creation of the FIO under Title V of the Dodd-Frank Act, the U.S. lacked a single authoritative voice on international insurance matters. The FIO now brings together under one Federal office the authority to coordinate U.S. international insurance efforts. Furthermore, its advisory authority to the Secretary of Treasury on "major domestic and prudential international insurance policy issues," will elevate insurance priorities to be more on par with banking and securities.

The Council enthusiastically supports FIO's international authority and particularly looks forward to having a single U.S. voice engaging with the International Association of Insurance Supervisors (IAIS), as opposed to the state insurance regulators and their trade association (the NAIC) who have no authority to speak for the U.S. government on insurance policy matters. We note that the state regulators, through the NAIC, remain involved with IAIS, and we believe their

technical expertise will remain important in supporting the FIO and IAIS efforts. But the single, authoritative voice of FIO is what is needed at this juncture.

The IAIS has, among other responsibilities, international standard setting authority granted by member nations of the G-20. The IAIS's standard setting authority, which is a fairly recent development, makes it even more critical that the interests of the U.S. insurance sector, from the market and regulatory perspectives, are methodically coordinated and represented by a federal office. The single voice that the FIO brings to the IAIS will be critical in ensuring that the U.S. perspective will be heard and heeded in that group's development of "principal" papers, which are intended to guide regulators around the globe on "best practices" in the development of insurance regulatory structures and rules. It is critical that the U.S. approach to regulation have a strong advocate in this process. To that end, we believe the FIO is better suited to represent American interests than representatives of the individual state insurance commissioners. FIO's voice will strengthen insurance regulation, business development, and the broader U.S. economy. We look forward to working with FIO, Congress, and international bodies on global issues impacting our sector and its global competitiveness.

In addition to international regulatory deliberations and standard-setting, the FIO has an important role working with USTR in advancing U.S. insurance interests in international trade discussions, which are critical to insurance brokers and the entire industry as the U.S. marketplace matures and insurance is increasingly global in scope. The Report strongly asserts FIO's role in this area.

Brokers' business interests in the international arena are driven by issues impacting access to foreign and emerging markets, increasing regulatory transparency overseas, servicing U.S. business clients abroad, boosting international regulatory cooperation, and the development of international regulatory standards. Market liberalization policies that ease access for U.S brokers and the insurance community will be a critical component to lifting the global economy, including the economy here at home, and creating American jobs. Market access and trade liberalization policies go hand in hand with economic growth strategies. The USTR has provided excellent leadership on this front for insurance brokers and in representing our interests

in trade negotiations. We are heartened that the Report addresses FIO's international trade role and look forward to FIO's increased participation in the area, which we believe can be of particular help in ensuring the USTR's success by using its bully pulpit to advance the interests of the U.S. insurance sector and by coordinating efforts to resolve any conflicts between the federal government and states over insurance.

Covered Agreement on Reinsurance Collateral: As brokers, we know that spreading risk globally is a key to providing the reinsurance capacity that the U.S. insurance market needs. We are pleased that the FIO report recommended that Treasury and USTR pursue a covered agreement on reinsurance collateral requirements, because this is an area where international cooperation is critical. Equally important, such a covered agreement is needed to forestall emerging foreign regulatory barriers to U.S. reinsurers

State laws generally require foreign reinsurers to deposit collateral in the U.S. for their reinsurance obligations. This requirement applies regardless of the reinsurer's financial strength, credit rating or history of claims payment. For the largest global reinsurers, this amounts to billions of dollars on static deposit in the U.S. and these amounts are unavailable to pay the very claims being secured. A recent NAIC Model Act, recognizing these difficulties, moves in the right direction but the patchwork implementation of such model provides little practical relief absent the uniformity that only a covered agreement is likely to provide. CIAB therefore agrees with FIO that a covered agreement is necessary to address cross-border harmonization of reinsurance collateral requirements.

FATCA: Finally, we note that the Report does not discuss Foreign Account Tax Compliance Act, or "FATCA." The law is designed to "incentivize" foreign financial institutions ("FFIs") to submit investment income reports for U.S. citizens who maintain accounts with them. The "incentive" is a big stick – any U.S. funds that are sent to an FFI are subject to a 30 percent withholding unless that FFI qualifies for an exemption. This greatly concerns Council members because premiums remitted to foreign insurers are subject to the FACTA withholding requirements unless the foreign insurer demonstrates that it qualifies for a withholding exemption. This includes premiums on property and casualty policies even though such policies

have no cash value and provide no financial investment income, and even though the foreign carriers that provide such coverage almost never offer cash value policies that would be subject to the FATCA reporting requirements. We believe that FATCA was not intended to cover such payments, and unnecessarily burdens insurance brokers and their clients with costly compliance obligations. For that reason, we have urged the Treasury Department to exclude property and casualty insurance premiums from FATCA coverage, to no avail thus far. As the federal government's insurance experts, we believe that FIO understands our concerns and we hope that FIO will use its influence to encourage exemption of property and casualty insurance from FATCA's withholding requirements.

Domestic – FIO's Recommendations for Federal Involvement Through National Standard-Setting and State Implementation Will Help Make the State Regulatory Environment More Efficient and Effective

On the domestic front, the Report highlights two issues important to Council members that illustrate how the federal government can affect change by establishing national standards and rules to be implemented at the state level. We are gratified by the Report's unequivocal call for final enactment of a uniform agent/broker nonresident licensure clearinghouse, the National Association of Registered Agents and Brokers (NARAB), as well as the Report's pledge to monitor state implementation of the surplus lines portion of the Nonadmitted and Reinsurance Reform Act (NRRA) provisions of the Dodd-Frank Act and determine whether federal action may be warranted in the near term.

As a preliminary matter, we note that the Report does not address a third domestic issue important to insurance brokers and businesses across the nation: the Terrorism Risk Insurance Act (TRIA), which is up for renewal this year. The President's Working Group on Financial Markets is studying the issue and will be issuing a report on TRIA later this year. We strongly support renewal of TRIA and we hope that FIO will be a strong voice for renewal of the backstop. TRIA has not cost the federal government a dime in insured losses, but has been critical in establishing a stable terrorism insurance market, allowing insurers to provide affordable terrorism coverage to policyholders across the country. Without TRIA, policyholders

needing terrorism coverage will face dramatic increases in premiums, if coverage is available at all.

NRRA Implementation

With respect to surplus lines taxation, the Report specifically states that FIO will continue to monitor state progress on implementation of the surplus lines provisions of the Dodd-Frank Act (the Non-Admitted and Reinsurance Reform Act (NRRA)), and determine whether federal action may be warranted in the near term. The Council strongly supports FIO's continued oversight of NRRA implementation by the states – and the prospect of future federal action if needed. As the Report suggests, the NRRA could be a model for insurance regulatory reform because it preserves state regulation while providing incentives for states to act in in a manner consistent with federal guidelines. But the states have not fully embraced the possibilities of the law. The Report recognizes, with almost palpable disappointment, that the states have not met this opportunity, which is the reason FIO's continued oversight is needed.

As the Report notes, despite Congress's best intentions in drafting the NRRA, the state implementation process has been marked by confusion and frustration. For brokers, this is particularly problematic with respect to the law's most important reform – surplus lines premium taxation.

Prior to the enactment of the NRRA, the collection and distribution of surplus lines premium taxes had been a confusing and complex challenge for surplus lines brokers for many years. The NRRA reforms addressed this problem through single state regulation; that is, by permitting only the home state of the insured to require the payment of premium taxes in connection with a surplus lines transaction or direct nonadmitted insurance placement. The statute leaves no ambiguity about the intended goal and provides that "[n]o state other than the home state of an insured may require any premium tax payment for nonadmitted insurance."

Although the NRRA's tax provisions are straightforward, because of the uncoordinated way in which the states have implemented the law, brokers still face unnecessarily cumbersome and costly compliance requirements in many states.

Most states, to their credit, have opted to tax – and keep – 100% of surplus lines premium tax for coverage provided to home state insureds. A small number of these states are taxing the coverage at the rate of the state in which the risk is located, forcing brokers to undertake the burdensome task of allocating risks and taxes. This method thwarts the clear intent of Congress to streamline and simplify how surplus lines taxes were collected. Moreover, it unnecessarily increases the frictional costs for consumers and insurance producers who must allocate risks across multiple states and then collect taxes at the different state rates. Most of these "100%" states, however, are taxing the entire premium at a single rate – their own. We think this is the easiest and most logical method of implementing the NRRA's premium tax provision and are encouraging the rest of the states to follow their lead.

Unfortunately, there are a number of states that continue to require brokers to allocate and pay surplus lines tax in accordance with the location of the risk and the rate of the state where the risk is located. Currently, five states participate in a premium tax sharing arrangement under NIMA, the Nonadmitted Insurance Multi-State Agreement. Those states are Florida, Louisiana, South Dakota, Utah, and Wyoming. Puerto Rico is also a member. If one of these jurisdictions is the home state of the insured, the premium tax must be allocated and submitted to the Surplus Lines Clearinghouse, operated by the Florida Surplus Lines Services Office. In addition to the tax, the Clearinghouse charges a filing fee of .30% for each submission, which effectively increases the tax rate on any policies filed through the Clearinghouse. Moreover, anecdotal evidence from brokers indicates that administrative costs in NIMA allocation states are approximately 2.5 times more than costs in the states that tax and retain 100% at their own rates.

The Council is currently in the process of soliciting, through Freedom of Information Act requests, tax sharing information from the NIMA states to determine how much of the premium taxes filed are actually shared among the states. Preliminary numbers indicate that those amounts are low and certainly do not justify the costs of compliance.

In addition to NIMA, nine states are members of SLIMPACT, the Surplus Lines Insurance Multi-State Compliance Compact. SLIMPACT is not operational at this time because, in accordance with the terms of the compact, in order to be effective ten states, or states representing 40% of all surplus lines premium volume, must adopt the compact. If SLIMPACT's clearinghouse becomes operational, the broker will be required to pay tax and report allocation information to the SLIMPACT clearinghouse in accordance with the rules and timeframes mandated by the SLIMPACT Commission for all transactions in which the home state of the insured is a SLIMPACT state.

Producer Licensing and NARAB

The Report discusses producer licensing at some length, noting the problems caused by the lack of uniformity across the states, the resulting regulatory burdens and costs, and the impact on consumers. The Report specifically cites information presented to FIO with respect to the excessive number of licenses required to be held by a single brokerage and its producers, noting that these duplicative administrative and regulatory burdens have "no corresponding consumer benefit." To address these issues, the Report strongly endorses adoption of the NARAB II legislation, and recommends that implementation of the legislation be monitored by FIO.

The Council has long supported adoption of NARAB II, and we welcome FIO's strong endorsement of the legislation in the Report. Moreover, we welcome FIO's interest in the long-term success of the organization as evidenced by the recommendation that the office monitor its implementation.

The Report makes two suggestions if NARAB is adopted: (i) the interests of consumers should "receive due consideration and remain a priority" and (ii) the interests of states that are not (and cannot) participate in the NARAB board (due to state law prohibitions) should be somehow integrated into the decision-making process of the new organization. We share these goals, and believe the NARAB II legislation currently pending in Congress provides the framework to

ensure that consumer interests and the interest of states that are not on the NARAB board to be heard.

The Council's efforts to improve and streamline state producer licensing requirements goes back decades. We were strong advocates of the NARAB provisions of the Gramm-Leach-Bliley Act (GLBA)[1] and the reforms put in place by the states since that time. Although insurance agent and broker ("producer") licensing processes have improved over the last decade and a half – thanks in large part to GLBA – there remain redundancies, inefficiencies and inconsistencies across the states that result in unnecessary costs on insurance producers and consumers due to the regulatory and administrative burdens the requirements impose. This is why The Council supports adoption of NARAB II, and the creation of NARAB.

We believe creation of NARAB is the only way to achieve comprehensive producer licensing reform. NARAB II creates a national "passport" for insurance producer licensing. Insurance producers licensed in their home states can obtain non-resident licenses for any and all other states through the NARAB licensing clearinghouse. It is optional for agents – so an agent can choose to go through NARAB or directly through the states. Moreover, NARAB would not replace or displace state insurance regulation. Indeed, the legislation takes great pains to ensure that there is no question regarding state authority, and clarifies the state's continuing role in the licensure process through the notice period and regulator participation in NARAB, as well as incorporation of the highest state standards in NARAB's licensing requirements.

State Insurance Agent and Broker Licensing Today

GLBA's NARAB provisions required that a majority of the 56 U.S. insurance regulatory jurisdictions[2] enact either uniform agent and broker licensure laws or reciprocal laws permitting an agent or broker licensed in one state to be licensed in all other reciprocal jurisdictions simply by demonstrating proof of licensure and submitting the requisite licensing fee.

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[1] Pub. L. No 106-102, 113 Stat. 1338 (1999).
[2] The 56 jurisdictions are the 50 states, the District of Columbia, Guam, the Northern Mariana Islands, Puerto Rico, Samoa and the Virgin Islands.

After enactment of GLBA, the state insurance regulators, through the NAIC, chose to pursue enactment of reciprocal licensing requirements, and pledged to ultimately exceed reciprocity by establishing uniform producer licensing requirements in all the states. The regulators amended the NAIC's Producer Licensing Model Act (PLMA) to meet the NARAB reciprocity provisions, and most of the states followed by enacting some sort of licensing reforms. In 2002, the NAIC officially certified that a majority of the 56 U.S. insurance regulatory jurisdictions met the NARAB reciprocity requirements, thereby averting creation of NARAB.[3] The NAIC currently considers 47 jurisdictions (46 states and the District of Columbia) are reciprocal for producer licensing purposes.

Even among the states deemed reciprocal, however, administrative inefficiencies and inconsistencies remain that affect every insurer, every producer and every insurance consumer. In a recent study, the Foundation for Agency Management Excellence (FAME)[4] compiled extensive data on state licensing laws and regulations, as well as implementation of those laws and rules. Despite similar requirements in many of the states, the research shows that differences and inconsistencies abound – whether its business entity lines of authority (required in approximately 30 states, but not required in the rest); pre-licensing education requirements (some states require no pre-licensing education, the rest require between 20 and 200 hours of education); producer appointments (some states require individuals to be appointed with carriers, some require agencies to be appointed, some require both, some require renewals, some are perpetual, etc.); and numerous other requirements. While these may seem like small issues, they can easily turn into large problem for entities with insurance producers licensed as residents in multiple jurisdictions: they must constantly renew licenses throughout the year, based upon the individual requirements in each state.

Reciprocity has helped smooth over some of these differences, but unless there is real uniformity in administrative procedures as well as statutory requirements, brokers – and insurance consumers – will continue to suffer from unnecessary costs.

[3] NAIC NARAB (EX) Working Group Report: Certification of States for Producer Licensing Reciprocity Adopted Aug. 8, 2002; NAIC Certification of States for Producer Licensing Reciprocity, Sept. 10, 2002.
[4] FAME is a 501(c)(3) charitable and educational organization administered by The Council of Insurance Agents & Brokers and is located in Washington D.C.

For example, many Council member firms continue to hold hundreds of resident and non-resident licenses across the country. For some, the number of licenses has actually increased since enactment of GLBA. One Council member, for instance, has approximately 5,000 licensed individuals, 3,100 of whom are licensed in multiple jurisdictions, who hold 76,100 licenses across the country. Another member has approximately 1,400 individuals holding 12,000 licenses nationwide. In addition to initial licenses, Council members face annual renewals in 51-plus jurisdictions, and must satisfy all the underlying requirements, such as pre-licensing and continuing education, as well as post-licensure oversight. This redundancy costs Council members anywhere from several hundred thousand to many millions of dollars annually to administer.

In addition to the lack of full reciprocity, the standards by which the states measure compliance with licensing requirements differ from state to state, as well. These include substantive requirements – pre-licensing education, continuing education and criminal background checks, for example – as well as the administrative procedures to comply with these requirements. In addition to the day-to-day difficulties the current set-up imposes, the lack of uniform application of law among the states inhibits efforts to reach full reciprocity. Some states may be disinclined to license as a non-resident a producer whose home state has "inferior" licensing standards, even a state with similar or identical statutory language. In fact, several states that have failed to adopt compliant licensure reciprocity regimes (notably California and Florida) claim their refusal is based on this absence of uniform standards – thus implying that the standards of other states do not measure up.

The NAIC has attempted to move the states toward uniformity. Following on the PLMA, the NAIC adopted uniform licensing standards (ULS), which include 42 separate standards purporting to establish uniform approaches to licensing issues ranging from an applicant's age, to education requirements, to examinations, to applications. The NAIC has spent most of the last decade encouraging the states to adopt the ULS, and in 2008 performed as assessment of every

state's compliance with the standards. A report was issued, and a follow-up was done in 2009.[5] The 2008 report and 2009 follow-up found a significant lack of uniformity across the states, particularly on licensure requirements such as fingerprinting/background checks, where divergent state approaches are extremely burdensome on producers.[6]

Even if there were broad state compliance with the ULS, however, producer licensing requirements would be far short of uniformity for the simple reason that a significant number of the "uniform standards" do not create a single requirement for the states to meet, rather they serve more as suggestions or a menu of options to guide state action.

Of the 42 standards, there are roughly 17 that do not require the states to meet a uniform requirement. Some of the 17 are clearer than others in their lack of standard-setting (Standard 12, for example, provides that the standard for failure of examination and re-testing is to be "determined by each state"), but all give the states flexibility that is unwarranted if the goal is to have the same requirements in every state.

These numbers – and, more critically, the regulatory and administrative burdens they represent – vividly demonstrate that, despite the improvements that resulted from the enactment of NARAB, comprehensive reciprocity and uniformity in producer licensing laws remains elusive, and it does not appear the NAIC and the States are capable of fully satisfying those goals. That is not a slight on the regulators – it is almost an impossible task getting regulators, legislators, and other stakeholders from 56 different jurisdictions to agree to a single set of licensing requirements and procedures – but it is the reason we need a national licensing framework.

The inability of the states to fully implement licensing reciprocity and to make real progress toward uniform laws and regulations has been demonstrated repeatedly in the dozen years since GLBA's enactment. The federal law put pressure on the states and resulted in real improvements in licensing processes, but the resistance to comprehensive change has stymied attempts to

[5] NAIC Producer Licensing (EX) Working Group, Producer Licensing Assessment Aggregate Report of Findings, Feb. 19, 2008; NAIC Producer Licensing (EX) Working Group, Producer Licensing Assessment Progress Report, Mar. 16, 2009.
[6] NAIC Producer Licensing (EX) Working Group, Producer Licensing Assessment Aggregate Report of Findings, Feb. 19, 2008, p. 14.

achieve comprehensive reform. As a result, brokers continue to face differing licensing obligations across the states, imposing administrative and financial burdens that affect not only brokers, but consumers as well. This is why The Council – as well as all other stakeholders, including the state insurance regulators, support enactment of the NARAB II legislation. And that is why we welcome the Report's endorsement of the legislation.

NARAB would be a self-regulatory national licensing authority operated by a presidentially-appointed Board of Directors. A majority of the Board would be state insurance regulators, with the remainder representing the various segments of the insurance industry.

NARAB membership would be voluntary. Insurance producers – agents, brokers, and agencies – who opt to become members of NARAB would have to obtain resident licenses from their home states before applying for NARAB membership. Once licensed in their home states, producers operating in multiple jurisdictions could apply for NARAB membership and one-stop nonresident licensing. To qualify for membership, a producer would be required to comply with NARAB's membership criteria. The NARAB Board would establish the membership criteria, which would include standards for personal qualifications, education, training and experience. In addition, NARAB member applicants would be required to undergo a national criminal background check if their resident state does not require one. Non-resident states would be prohibited from imposing any requirement upon a member of NARAB that is different from the criteria imposed by NARAB.

Applicants would have to pay the fees mandated by each State to receive licenses. Moreover, NARAB would levy and collect assessments from members to cover administrative expenses. The licenses would be obtained from, and the fees would be paid to, NARAB, which would ensure that appropriate licensure applications are filed with, and the requisite fees paid to, each State from which NARAB members seek a license. In other words, NARAB would function as a clearinghouse to more efficiently process multi-state license applications.

NARAB membership would be renewed annually, and NARAB would have the authority to bring disciplinary actions to deny, suspend, revoke or decline renewal of membership. The

membership criteria for any NARAB member must meet and exceed the highest professional requirements that currently exist among States. Thus, as a practical matter, to be eligible for NARAB membership a producer would have to effectively satisfy the substantive licensing requirements for all the States.

NARAB would thus be given the authority, among other things, to:

- Create a clearinghouse for processing insurance producer licenses which would avoid duplication of paperwork and effort state-by-state;
- Issue uniform insurance producer applications and renewal applications to apply for the issuance or renewal of state licenses;
- Develop uniform continuing education standards and/or establish a reciprocity process for continuing education credits;
- Create a national licensing exam process; and
- Utilize a national database for the collection of regulatory information concerning the activities of insurance producers.

Finally, the legislation does not seek to replace or displace state insurance regulation. Indeed, the bill very clearly retains state regulatory authority over insurance producers. Although NARAB would have an important role in the licensing of non-resident insurance producers, the bill clarifies the state regulators' continuing role in the licensure process through the notice period and regulator participation on the NARAB Board and in standard setting.
Moreover, state regulators would continue to supervise and discipline producers, and would continue to enforce state consumer protection laws.

Conclusion

In conclusion, we would like to thank you, once again, for allowing The Council to share our thoughts on the Report and the role of FIO. We believe the Report provides a comprehensive roadmap for the federal and state governments – and all stakeholders – in the pursuit of effective reform and modernization of insurance regulation in the United States. As insurance brokers, we

are particularly interested in – and pleased with – the Report's recommendations regarding international issues, as well as NRRA implementation and NARAB II. And we look forward to continuing to work with FIO and you to reach those goals.

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American Insurance Association

Statement by

J. Stephen ("Stef") Zielezienski

Senior Vice President & General Counsel

American Insurance Association

before the

Committee on Financial Services

Subcommittee on Insurance, Housing and Community Opportunity

United States House of Representatives

"The Federal Insurance Office's Report

on Modernizing Insurance Regulation"

February 4, 2014

Thank you, Chairman Neugebauer, Ranking Member Capuano and Members of the Subcommittee. My name is Stef Zielezienski and I am senior vice president and general counsel of the American Insurance Association ("AIA"). I appreciate the opportunity to participate in today's hearing on a subject that is critical to AIA and its members: the state-based system of insurance regulation and recommendations for strengthening that system for the benefit of all interested parties.

AIA represents approximately 300 major U.S. insurance companies that provide all lines of property and casualty insurance to consumers and businesses in the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), enacted in the wake of the 2008 financial crisis, established the Federal Insurance Office (FIO) as the first federal agency principally focused on the business of insurance. Among other functions, Dodd-Frank requires the FIO to ". . . study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States." As FIO prepared its report, AIA submitted extensive comments (see Appendix A) that identified key concerns with the state system and recommended improvements. Notably, AIA did not view the FIO report as a chance to revisit old debates about the situs of insurance regulation, but as an opportunity to focus attention on substantive concerns with the existing U.S. insurance regulatory system, and identify ways to make the state-based system more effective and efficient.

As is the case with our testimony today, our comments to FIO were guided by AIA's long-held view that the insurance regulatory system should be focused on the core functions of financial solvency and market conduct regulation, while leaving pricing and policy form decisions to the marketplace. We have consistently held that the regulatory system – domestically and internationally - should support the growth of competitive markets. Advancing market competition empowers consumers and provides them with purchasing options, which in turn enhances affordability and availability. Competition is the best regulator of insurance rates, using market discipline as the instrument of enforcement and appropriately focusing regulation on sound financial condition and a company's actions in the marketplace. With that in mind, we believe that the most constructive way to look at the report - "How to Modernize and Improve the System of Insurance Regulation in the United States"- is to view it as a forward-looking document intended to address the many regulatory challenges facing the industry today and to provide a platform for market-oriented solutions to those challenges. As we stated upon its release, FIO's report provides a valuable guidepost for collectively working toward improvements that lead to greater regulatory effectiveness, efficiency, and marketplace competition.

Our perspective is also shaped by the recent financial crisis and the ongoing implementation of Dodd-Frank. As a result of these events, insurers must manage their businesses in a tripartite environment in which state regulation, federal bank holding company and systemic risk supervision, and international harmonization and convergence must be balanced and navigated

without disruption. As such, it is imperative that the industry and the U.S. financial services regulatory community work toward the common goals of ensuring and promoting vibrant and competitive insurance markets.

EFFICIENCY AND EFFECTIVENESS

In the areas of effectiveness and efficiency of the state-based insurance regulatory system, FIO addresses numerous issues and makes a series of recommendations that we believe are intended to increase uniformity among the states and thus improve efficiency and effectiveness. While AIA agrees that there is a need for greater regulatory uniformity across the states, that should not be the sole objective. Uniformity should be viewed through an outcomes-based lens that also considers whether or not uniformity enhances the market environment. We will highlight a few areas in the FIO report of particular importance and would refer you to the appendix for a more comprehensive discussion of the issues, including specific examples.

Commercial Lines Product Regulation Reform

AIA concurs with FIO's conclusion that commercial lines insurance regulation should continue to be modernized so that insurers may best meet the needs of their commercial customers with new and innovative products. The FIO report notes that "[r]egulatory approval of policies sold to sophisticated commercial policy holders, . . . often impose substantial delay."[1] To address this concern, FIO calls on the states to develop standardized policy forms or ". . . some

[1]Federal Insurance Office, U.S. Department of the Treasury, *"How to Modernize and Improve the System of Insurance Regulation in the United States"* p. 51 (December 2013) ("FIO Report").

mechanism for interstate reciprocity, to streamline and improve the regulation of commercial products." Establishing or broadening the interstate compact to encompass commercial lines policy forms is a recommendation worth exploring, particularly if it leads to a shorter timeline for the introduction of new commercial policy forms into the marketplace. However, while the alternative recommendation to develop standardized commercial lines policies may produce uniformity, it is unlikely to be effective because commercial insurance buyers demand differentiated products tailored to their varied business needs and evolving risks. Indeed, as FIO and the states explore the streamlining of government product controls for commercial lines policies, they may well find that prior review and approval are outdated regulatory tools that are inhibiting business innovation.

Government price controls: Rate regulation vs. risk classifications

As we stated in our comments to the FIO, the effectiveness of the state system is undercut by government rate and policy form regulation. Substantial evidence and examples indicate that the effect of rate and form regulation has over time produced rate suppression and limited product innovation. In the worst cases, government price and product controls threaten company solvency, increase the growth of residual markets, and limit consumer options. An increasingly populated residual market should not be a by-product of government regulation. Where government price controls are exercised in a muscular way to suppress rates below the level of the risk, that increase may also be accompanied by a flight from the state of insurers willing to write policies. This is a toxic regulatory mix, creating an environment that constrains private market capacity and concentrates risk in these markets of last resort. As government

rate suppression persists in such an environment, the real costs of risk are masked and are not well understood by consumers. The report acknowledges these harmful effects by noting the "many empirical studies [that] suggest rate regulation, particularly in auto and homeowner insurance, may adversely impact market supply resulting in higher prices and an increase in market share of the residual markets."[2] FIO recommends that states identify rate regulatory practices ". . . that best foster competitive markets for personal lines insurance."[3]

At the same time, however, the report contemplates the adoption of uniform federal standards for use of risk assessment tools. Risk classification and assessment is a part of the underwriting and rating process. Thus, if the latter recommendation is pursued, the result would be just another form of rate regulation at a more granular level. If insurance rate regulation is harmful, it should be jettisoned in favor of competitive pricing and not be "reintroduced" in the form of national risk classification/assessment standards.

AIA stands ready to work with the states and FIO to identify rate and form regulatory practices that limit competition and consumer choice and replace them with policies that enhance competition and empower consumers through expanded options.

Market conduct regulation reform

Periodically, the states carry out market conduct and financial examinations of insurance companies. In general, financial exams are coordinated among the state regulators with the company's domiciliary regulator taking the lead. The processes employed by states to conduct

[2] FIO Report, p. 54.
[3] FIO Report, p. 54.

market conduct exams are far from uniform. FIO's report makes several recommendations to streamline and improve the process by which the exams are conducted. AIA supports the recommendations in this area, particularly the adoption of uniform examination standards and the establishment of standards for contract examiners.

COMPETITIVENESS

Any statement or report on the future of insurance regulation would be incomplete without addressing the significant challenges facing insurers with U.S. operations at the international level. Today's insurance market is global and is becoming increasingly more complex. As such, it is useful to view this set of issues through the prism of competitiveness. Last June, this Subcommittee held a hearing entitled "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers." That hearing highlighted the importance of international regulatory issues and the need for cooperation among all regulators to ensure a level playing field for all market participants. AIA supports the call for a unified approach by the U.S. financial services regulators.

We continue to stress the need to develop a single consistent U.S. position that removes barriers to U.S. competitiveness while at the same time preserving the domestic laws and regulations that currently work for insurers and consumers. This is certainly easier said than done due to existing constitutional and statutory limitations that apply to those charged with developing, negotiating, and implementing any new rules for a complicated set of issues, including capital standards, accounting rules, the designation of Globally Systemically Important

Insurers (GSIIs), and group-wide supervision. The stakes are high and we must all be pulling in the same direction to get it right.

In this regard, one specific international recommendation in the report concerns the U.S. Treasury Department (Treasury) and the United States Trade Representative (USTR) pursuit of a covered agreement on reinsurance collateral in line with the National Association of Insurance Commissioners' (NAIC) credit-for-reinsurance model law and regulation. This could be a positive development in the states with uniform implementation of the NAIC's own reinsurance collateral model.

Beyond this specific example, AIA continues to support FIO's engagement on international issues to present a unified U.S. position, in coordination with the NAIC and state regulators, and – now - the Federal Reserve. That said, FIO should defend the U.S. state-based regulatory system where it has worked and strive to avoid duplicative -- or worse, contradictory -- regulatory standards that will erode the competitiveness of the U.S. insurance industry.

Conclusion

The overall objective of modernizing and improving U.S. insurance regulation should be to promote the growth of healthy, competitive insurance markets at home and abroad that will ultimately benefit and protect insurance consumers while emphasizing safety and soundness. The FIO report affirms these essential goals. Achieving these goals will require that all stakeholders - FIO, state insurance regulators, international bodies, and federal financial regulators – work together. While we have identified several areas of significant importance, it

is important to remember that they should not be considered in isolation. They are all essential pieces of the insurance regulatory puzzle. All stakeholders must cooperatively find a way to fit those pieces together to ensure and promote vibrant and competitive insurance markets. AIA stands ready to work with all stakeholders to advance these goals.

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December 16, 2011

VIA FEDERAL eRULEMAKING PORTAL

Department of the Treasury
Federal Insurance Office
MT 1001
1500 Pennsylvania Ave., N.W.
Washington, DC 20220

RE: Public Input on the Report to Congress on How to Modernize And Improve the System of Insurance Regulation in the United States

Ladies and Gentlemen:

The American Insurance Association ("AIA") appreciates the opportunity to submit comments on the Federal Insurance Office's ("FIO") notice published in the October 17, 2011, Federal Register entitled "Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States." ("FIO Study Request")[1] AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses, writing more than $117 billion annually in premiums. Our membership includes U.S. insurers that write insurance only within the U.S., U.S. insurers that write insurance inside and outside the U.S., and the U.S. subsidiaries of multi-national insurers. This diversity gives us the ability to analyze issues from many perspectives and enables us to draw on the global experience and expertise of our companies with many forms of insurance regulation.

[1] 76 Fed. Reg. 64174 (October 17, 2011).

As regulated insurance companies, our members have a substantial stake in maintaining an effective and efficient system of insurance supervision that fosters the growth of vibrant private, competitive insurance markets. Moreover, because AIA's members also provide property-casualty insurance in every significant international market, we have a considerable interest in making certain that the U.S. regulatory system does not lead to market disruption or disadvantage U.S. competitiveness abroad.

For many years, AIA has urged Congress to consider market-oriented optional federal chartering ("OFC") proposals. Our support for OFC has never been based solely on regulatory situs, but grounded principally on the need to re-focus the American insurance regulatory system on core functions such as financial solvency and market conduct regulation while leaving pricing and policy decisions to the marketplace. We also believe that government regulation should be employed in ways that support the growth of competitive, private markets. Government participation in the marketplace is appropriate primarily to provide a safety net when consumers cannot obtain insurance through the private market or where there is long-term private market dysfunction (such as that associated with insuring against the risk of loss from terrorism, given the characteristics of that risk). Under no circumstance should the regulatory system be a source of risk to insurers and consumers. To the extent that reforms can be achieved in the state-based system, we have consistently supported them, as well. This has achieved limited success in some states, but the current supervisory system has been unable to effectively respond on a national basis.

Our members' interest in an effective and efficient regulatory system that promotes open, private insurance markets is likewise aligned with consumers' interest in having a broad range of price and insurance product options offered by financially sound companies. In fact, such a system would empower consumers by enabling insurance supervisors to focus their scarce regulatory resources in a more effective manner.[2]

[2] The FIO Study Request also asks for public comment on the degree of consumer protection in the U.S. insurance regulatory system, including "access by traditionally underserved communities and consumers, minorities, and low- and moderate-income persons to affordable insurance products." 76 Fed. Reg. at 64175. Consistent with our submission, AIA believes that allowing rates and product options to be open to competition in the private marketplace (rather than subject to government oversight) is the best way to maximize the availability of policy options for those communities and consumers at prices that both reflect the risk and are sharpened by competition.

SUMMARY AND RECOMMENDATIONS

Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") establishes the FIO and empowers that office, through this study, to examine the state-based insurance regulatory system in the United States in light of the global financial crisis, and make recommendations to improve and modernize that system. We believe that the areas for public input identified in the FIO Study Request fall into three broad categories: (a) effectiveness, (b) efficiency, and (c) competitiveness.

Our comments are ultimately guided by the fundamental belief that the insurance supervisory system should protect consumers and further their interest by regulating for solvency and encouraging the maximum amount of private insurance competition.

Effectiveness. AIA believes that the effectiveness of the state-based regulatory system is undercut by government rate and policy form regulation. Both of these regulatory functions – where utilized as tools to artificially suppress rates or to keep insurance products from the marketplace – discourage companies from writing policies and run counter to the financial solvency regulatory mission, generating regulatory risk. Perhaps more importantly, use of these tools by regulators harms consumers. Government price controls inevitably mask other societal problems and generate moral hazard by encouraging consumers to amass more risk without pricing that risk appropriately or promoting the use of mitigation tools that would reduce the cost of insuring against that risk. States that employ heavy-handed, often politically motivated, rate regulation have seen residual market populations increase exponentially while the number of competing insurers declines.[3]

In many cases, as government efforts to control insurance rates increase, insurance prices become more volatile and subject to cross-subsidization.[4] In the worst instances, companies are forced to flee the jurisdiction to maintain a healthy business model, triggering growth in residual markets or the creation of restrictive government mechanisms that replace the private market in order to further suppress rates below those commensurate with the level of risk presented. Government product controls can similarly limit the range of product choices available to consumers by discouraging new market entrants, as well as existing competitors from developing new products. This adversely affects insurance rates and denies consumers the

[3] *See, e.g.,* Philip O'Connor and Eugene Esposito, "Modernizing Insurance Rate Regulation: Tacking to the Winds of Change," at pp. 10 – 13 (Apr. 26 2001) (presented to the National Conference of Insurance Legislators) ("O'Connor & Esposito").

[4] *Id.* at pp. 10 & 14.

benefits of robust market competition. Ironically, in commercial lines, such barriers have also led to businesses being forced to transfer their risks to alternative market mechanisms that create greater consumer risk and provide less consumer protection.

Recommendation: To address concerns with the effectiveness of the regulatory system, AIA recommends that the FIO study the effects of U.S. rate and policy form regulation of property-casualty insurers in personal and commercial lines, including the extent to which such regulation undermines competition in private markets, decreases consumer choice and detracts from the goals of financial solvency oversight. The study should be comprehensive and build on the large body of existing work. The FIO should set forth recommendations to align the system more closely with safety and soundness/solvency goals and to foster the growth of private property-casualty insurance markets.

Efficiencies. The nature of the state-based regulatory system results in a patchwork of standards. Even when the states signal their intent to adopt a single standard (e.g., via a National Association of Insurance Commissioners ("NAIC") or National Conference of Insurance Legislators ("NCOIL") model), that standard is prone to inconsistent implementation and enforcement across states. Inconsistent application of regulatory standards is compounded when states fail to coordinate effectively on a particular issue. These inefficiencies result in added costs of providing the insurance products and, in some instances, may affect the ability of consumers to obtain needed coverage. The costs and burdens associated with lack of uniformity or inconsistent application of standards from state to state are self-evident for insurers that do business regionally or nationally, and can generate excessive costs in many critical areas, including conforming rate and product filings, licensing, corporate governance, market conduct, financial reporting and accounting, and taxation. This problem is exacerbated by differing case law that may apply from jurisdiction to jurisdiction.

Where states adopt varying regulatory standards or inconsistently apply them in response to a perceived local insurance problem, regulations often live on long after market or environmental developments have overtaken the need for them. In those instances, the continued application of outdated regulations hampers the insurance market and denies consumers access to product benefits or reduced rates.

Recommendation: Charge the FIO with developing a non-regulatory role to coordinate state supervision, establish more uniform regulatory standards, help assure uniform and rigorous cost/benefit analysis consistent with international norms, and foster consistent application of

those standards. Catalogue instances where states continue to apply regulation even where the standards have outlived their utility, and prioritize those standards for sunset.

Competitiveness. While the growth of healthy, competitive private markets should be an overarching goal of any sound regulatory system, AIA believes that there is a particular need to emphasize this objective in the current global regulatory debate. The debate demands that the U.S. develop a consistent position on outcomes-based regulation that removes the U.S. regulatory system as an impediment to U.S. competitiveness abroad and promotes increased trade and market access on a level competitive playing field, as opposed to heightening the risk of market disruption. In this regard, it is imperative that the U.S. support those domestic laws and regulations that work for U.S. insurers. Conversely, consistent with our approach to examining the effectiveness and efficiency of the state-based regulatory system, the U.S. should be open to scrutinizing those aspects of regulation that have no place in our modern regulatory era. For instance, the U.S. system of rate regulation for property-casualty insurance does not exist in other countries and creates immediate, fundamental structural differences in regulatory approach that lead to unsound outcomes. The states, even when acting through the NAIC or NCOIL, have not been able to provide an *authoritative* U.S. voice on these matters at the international level. This does not reflect poorly on the state regulators or legislators, but is simply a consequence of their limited jurisdiction. Moreover, even if the states were legally capable of speaking with one voice, the U.S. Constitution vests the foreign affairs power exclusively in the federal government.

Recommendation: The FIO's authority to engage at the international level on prudential insurance matters should be fully implemented and expanded where necessary to preserve U.S. competitiveness and promote sound regulatory policy. In addition, the FIO should be encouraged to coordinate with the state insurance regulators, the NAIC, and the industry on an outcomes-based regulatory approach that works for all interested parties.

BACKGROUND

The "Federal Insurance Office Act of 2010" enacted as part of the Dodd-Frank Act, establishes the FIO within the Treasury Department and grants it non-regulatory authority in a number of areas related to "all lines of insurance except" health, long-term care, and crop insurance.[5] Included within the FIO's sphere of authority are several reporting obligations to the President and the Congressional committees of jurisdiction, including a requirement that the FIO Director "conduct a study and submit a report to Congress on how to modernize and improve the

[5] Dodd-Frank Act § 502.

system of insurance regulation in the United States."[6] The study and report are required to include consideration of the following factors: (a) systemic risk regulation of insurance; (b) capital standards and the relationship between capital allocation and liabilities; (c) consumer protection; (d) uniformity of regulation; (e) consolidated regulation of insurers and affiliates; and (f) international coordination of insurance regulation. The study and report must also evaluate the potential for full or partial federal insurance regulation, including the ability of such a regulatory system to eliminate or minimize regulatory arbitrage and protect policyholders and other consumers, as well as the influence of foreign insurance regulation and the impact of any federal resolution authority.

The FIO Study Request seeks public input on all of these considerations. AIA's position on the costs and benefits of federal insurance regulation – specifically, market-oriented OFC proposals – is well-documented. The public record is replete with studies that support or oppose OFC legislation and outline the ability of a federal regulator to carry out traditional supervisory functions and avoid regulatory arbitrage. Similarly, our position in opposition to the designation of regulated property-casualty insurers as "systemically important financial institutions" and the attendant application of heightened supervisory standards and a federal resolution alternative have been directly provided to the Financial Stability Oversight Council ("Council" or "FSOC") on several occasions over the past year and are on the public record. Accordingly, this submission will not address those areas of the study.[7]

Instead, AIA's comments focus on the overall objective of modernizing and improving U.S. insurance regulation, taking this opportunity to provide our perspective – as a trade association of leading U.S. property-casualty insurance companies engaged in commerce throughout the United States and around the globe – on those elements of state regulation that, for reasons of effectiveness, efficiency, or competitiveness, inhibit the U.S. system from maximizing the growth of healthy competitive markets to the ultimate benefit and protection of insurance

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[6] Dodd-Frank Act, § 502(a) (31 U.S.C. § 313(p)).

[7] *See* Comments of the American Insurance Association in Response to Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Docket No. FSOC-2010-0001) (Nov. 5, 2010) (available at www.regulations.gov, *Doc. ID FSOC-2010-0001-0029 through FSOC-2010-0001-0029.3*) ("AIA ANPR Comments"); Comments of the American Insurance Association in Response to Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Docket No. FSOC-2011-0001) (Feb. 25, 2011) (available at www.regulations.gov, *Doc. ID FSOC-2011-0001-0027*) ("AIA NPR Comments"); Comments of the American Insurance Association in Response to Second Notice of Proposed Rulemaking and Proposed Interpretive Guidance Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Docket No. FSOC-2011-0045) (Dec. 16, 2011) (available at www.regulations.gov,) ("AIA Second NPR Comments").

consumers. By doing so, and providing examples of regulatory risk in the U.S. system in the process, AIA hopes that its preliminary recommendations will provide a platform for the FIO to undertake further study and public discussion that will establish the foundation for improvements to that system.

U.S. Insurance Regulation

In the United States, property-casualty insurance companies are chartered and obtain licenses to conduct business at the state level. Marketing, advertising, and policyholder service practices are regulated separately by each state in which a company conducts business in accordance with that state's laws and regulations governing such practices.[8] States also assess the solvency of insurers, with principal responsibility being carried by a company's domiciliary regulator. In connection with solvency oversight, companies are required to prepare quarterly and annual financial statements based on statutory accounting principles and to file those statements with their respective domiciliary regulators, other state regulators in jurisdictions where the company does business, and with the NAIC. Much of the uniformity of the state financial regulatory architecture is an outgrowth of Congressional scrutiny in the early and mid-1990s of the state system, led by Representative John Dingell (D-MI), following a number of large insurance company insolvencies in the late 1980s.[9] This inquiry, coupled with the threat to take away regulatory authority from the states, also resulted in the NAIC's financial solvency regulation accreditation process for state insurance departments. Accreditation has now grown to include every U.S. state and the District of Columbia.

States also conduct periodic (once every three to five years) financial and market conduct examinations of companies. While financial examinations are largely coordinated among the state regulators and led by a company's domiciliary commissioner, market conduct examinations are far less uniform and predictable.

Each state also regulates the terms of the property-casualty insurance policy forms marketed and sold to consumers in the states. States require companies and licensed advisory organizations to file each policy form used in the state for review. A number of states require regulatory approval before the form is used in the state – particularly for personal lines forms

[8] Congressional Research Service Report for Congress, "Insurance Regulation: History, Background and Recent Congressional Oversight," at CRS-3 (Feb. 11, 2005) ("CRS Report on Insurance Regulation").

[9] U.S. Congress, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, "Failed Promises: Insurance Company Insolvencies," 101st Congress, 2nd sess., Committee Print 101-P (Washington: GPO, 1990); U.S. Congress, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, "Wishful Thinking: A World View of Insurance Solvency Regulation," 103rd Cong., 2nd sess., Committee Print 103-R (Washington: GPO, 1994).

such as private passenger automobile and homeowners' insurance – while others simply retain the authority to review the form for compliance with state law, along with the right to disapprove that form after it has already been marketed, should the state determine the form is noncompliant. The regulation of policy terms and the degree of review and approval varies from state to state (and sometimes from property-casualty line to property-casualty line within a given state), and can depend on state court decisions construing policy language as a matter of state common law of contracts.

Likewise, every state except Illinois regulates insurance rates for one or more property-casualty lines, with the level of regulation ranging from "prior approval" of rates to "flex bands" that permit an insurer to adjust rates upward or downward within a percentage range to "use and file" review that permits an insurer to use the rates in the market, but requires that insurer to file the rates with the state for review.

Rate regulation is unique to the property-casualty insurance sector, which remains as perhaps the only competitive U.S. industry that is still subject to government price controls. Like policy form regulation, the degree of regulation and the process applied to insurance rates depends on state law and the political environment at any particular time.

Historically, property-casualty rate regulation has its roots in protecting insurers against numerous company insolvencies in the wake of large catastrophic losses. Prior to the advent of federal antitrust laws, in the 1800s, fire insurers formed rating cartels that were based on maintaining insurance rates that were high enough to allow for adequate reserves to cover future large fire losses. The cartels were buttressed by state agencies that collected financial condition information and established reserving standards.[10]

In the wake of the mass fire insurer failures following catastrophic losses from the 1906 San Francisco Earthquake, many states followed New York's lead in recommending the creation of rating bureaus to ensure rate adequacy and help protect against future insolvencies.[11] The U.S. Supreme Court's seminal decision in *U.S. v. South-Eastern Underwriters Association*[12] challenged the rating bureau activities under federal antitrust law, which paved the way for the McCarran-Ferguson Act. That Act, in turn, created an incentive for states to regulate the business of insurance comprehensively, including rates, so that supervisory authority over insurance would remain at the state level. It also created an incentive for insurers to support

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[10] CRS Report on Insurance Regulation at CRS-6.

[11] *Id.* at CRS-6 through 7.

rate regulation as a means of protection from the adverse, unknown consequences of federal antitrust litigation over their rate-making activities.

The rate regulatory construct that emerged in the states prohibited rates that were "excessive, inadequate, or unfairly discriminatory" and required the licensing and supervision of the rating bureaus. As rate regulation has evolved, it is safe to say that regulatory emphasis has been placed squarely on preventing so-called "excessive" rates, while the "inadequacy" portion of the rating standard has taken a backseat and has largely become irrelevant as stronger financial regulatory tools and standards have advanced.

Interestingly, both rate and policy form regulation have been justified because of the consumer's unequal bargaining position to insurers with respect to the terms of the insurance contract, a principle that often forms the basis for state court decisions construing the rights and obligations of parties to contracts.[13] In addition, rate regulation has also been defended with respect to those insurance products that consumers are "mandated" by state law to purchase. Thus, while the McCarran-Ferguson Act was enacted largely to delegate regulatory authority over the business of insurance – a product under the interstate commerce jurisdiction of the federal government - to the states and to balance regulatory and antitrust policy favoring competition, the rate regulatory aspects and rationales have largely tilted in favor of regulation while ignoring the counterbalance of market competition.

Lessons Learned from the Global Financial Crisis

The Dodd-Frank Act represents the first comprehensive national legislative response to the global financial crisis. Indeed, the United States is the only country thus far to enact legislation geared toward major regulatory reform in the wake of the crisis. While the legislation covers a wide range of areas of financial oversight, there is an understandable emphasis on identifying those institutions and activities that could be a potential source of systemic risk. Once identified, the legislation provides authority to recommend additional standards to oversee systemically risky activities on an industry-wide basis, and to apply federal heightened prudential regulation to "systemically important" firms and an orderly resolution alternative should those firms fail. The Dodd-Frank Act's focus on containing systemic risk is recognition that financial solvency and safety and soundness regulation are the highest and best consumer protections.

The treatment of insurance under the Dodd-Frank Act largely reflects Congress' conclusion that, with a few notable exceptions, the regulated "business of insurance," while undoubtedly

[12] 322 U.S. 533 (1944).
[13] *Id.* at CR5-2.

important to our economy, does not threaten U.S. financial stability. For example, Title II of the Act establishes an orderly liquidation alternative for failing systemically important financial institutions, but then expressly defers to the existing state-based insurance resolution system where insurance companies are part of such a failing institution.[14] Thus, while the legislation preserves the ability to address unregulated activities and companies whose range and scope of activities in the financial system may warrant scrutiny, it implicitly acknowledges that regulated insurance companies represent a low level of systemic risk.

Congress' conclusion with respect to the treatment of insurance under the "systemic risk" provisions is grounded in the nature of the business itself and the supporting regulatory architecture. In many ways, the conclusion is compelled by the industry's business model. Insurance companies – especially property-casualty insurers - operate under a different business model than other financial firms, based on an "inverted cycle of production"[15] where premiums are received up-front. "This means that the product - the contractual promise to pay an agreed amount only if a particular event occurs in the future - is sold at a price, the insurance premium, which has to be estimated before knowing the actual cost of the product which depends on probabilities of occurrence and severity of future events."[16] The property-casualty industry business model is premised upon collecting sufficient premiums in advance from each customer to fund likely covered claims from all similarly situated customers. Hence, there is less need for a well-managed property-casualty insurer to borrow, which means that there is a much lower likelihood of becoming highly leveraged. When insurance companies do borrow, they generally do so through the issuance of long-term debt or surplus notes in the public and sometimes private placement markets, for the purpose of long-term strategic positioning. They do not continuously tap very short-term funding vehicles such as commercial paper issuance for their day-to-day funding requirements. In short, the nature of the insurance business itself – which requires sufficient capital on hand to pay anticipated, but unknown losses covered by contract - promotes increased financial stability.

The primary risks for insurance firms are underwriting and market risks. With regard to market risks, insurance assets and liabilities are generally linked, and risks are comparatively longer term and more diversified than in sectors such as banking. Relevant types of risks pooled are typically "real events" such as theft, fire, sickness, death and natural hazards. These are

[14] Dodd-Frank Act § 203(e).

[15] "Systemic Risk and the Insurance Sector," International Association of Insurance Supervisors, p. 2 ("IAIS Paper") (Oct. 25, 2009).

[16] IAIS Paper at 2.

exogenous events and mostly independent in nature, as opposed to other types of financial risk.

The insurance business model also helps shield property-casualty insurers from the so-called "run on the bank" scenario frequently used to describe the contagion effect of systemic risk. Unlike customer deposits held by banks, payment of insurance policy claims depends on the occurrence of a covered event. Therefore, as a practical matter, insurance consumers do not have "on-demand" access to insurance assets as they do with other financial institutions that do not operate according to an inverted cycle of production.

Not even extreme natural disasters such as a major hurricane are likely to produce a systemic risk on the part of any property-casualty insurer. Even when a particular insurer is imperiled, that insurer's financial condition is highly unlikely to present systemic issues for the financial system because of the insurance guaranty fund system and the ability to effect an orderly wind-down of that insurer's operations through the state-based solvency laws. Indeed, our consistent experience with these types of mass natural catastrophes is that the crisis is short-lived, unless otherwise prolonged by regulatory intervention, because additional capacity is promptly supplied by new market entrants due to the lower barriers to entry for property-casualty insurance (as was the case with property insurance capacity following Hurricanes Andrew and Katrina).[17] Perhaps most importantly, natural catastrophes and other extreme insured events have little or no correlation to the stability of the broader financial markets, suggesting the absence of any interconnectedness. Even insurers' investments in other financial services do not create systemic interconnectedness because of the insurance business model, regulatory constraints and the competitiveness of property-casualty lines of insurance.

In addition to aiding a rapid response to any capacity shortages, the competitive market structure in property-casualty insurance further reduces the possibility that any individual company could be a source of systemic risk. There are thousands of property-casualty insurers operating in the United States. According to the most recently available data from A.M. Best based on insurer 2010 Annual Statements filed with the National Association of Insurance Commissioners ("NAIC"), there were 361 homeowners insurers, 305 personal automobile liability insurers, 338 commercial automobile liability insurers, 276 workers' compensation

[17] Following Hurricane Katrina, Ariel Reinsurance Ltd. commenced operations with an initial focus on property catastrophe excess coverage with $1 billion of equity capital. *See, e.g.*, http://www.arielredev.com/arielre/sites/default/files/ArielRe_181205.pdf. With respect to man-made catastrophes such as terrorism that have different insurability characteristics, the capacity response has involved both federal legislation (the Terrorism Risk Insurance Act and its two legislative extensions of the program) and the private market. For example, with respect to the latter, AXIS Capital commenced operations in late 2001, with approximately $1.7 billion available to provide terrorism risk insurance. *See* http://www.axiscapital.com

insurers, 333 commercial multi-peril (non-liability) insurers, and 291 commercial liability insurers writing those lines of business in the United States. None of these lines was considered to be even moderately concentrated when applying a traditional Herfindahl-Hirschman Index ("HHI") concentration analysis.[18]

Even if a "large" property-casualty insurer failed and no longer wrote business in these major lines, based on the number of competing companies and lack of market concentration in those lines, there would be no capacity shortage or substantial market disruption because other insurers would be in a position to step in promptly and provide insurance protection for the failed company's policyholders. Indeed, competition within the property-casualty industry remains vigorous. Even at the height of the global financial crisis and accompanying decline in asset values, property-casualty insurers remained well-capitalized by any historical measure. A review of year-end surplus levels shows that the property-casualty sector continued its robust recovery from the modest recessionary dip of 2007-2008 with regulatory capital (surplus) increasing by 18.2% in 2010 to $580.5 billion.[19] To illustrate the financial strength and capacity of property-casualty insurance, we note that insurance regulators raise red flags when premium to surplus ratios exceed 3 to 1. With a 2010 surplus of $580.5 billion and aggregate net written premiums of approximately of $430.1 billion,[20] the property-casualty insurance industry currently is operating at a ratio of 0.74 – well within the financial adequacy comfort zone. The Council, in its annual report, both recognized the capacity of the property-casualty industry to withstand the financial crisis, as well as its current stability.[21]

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[18] In 1982, the Antitrust Division of the U.S. Department of Justice adopted specific guidelines for challenging mergers based on the Herfindahl-Hirschman Index (HHI) of market concentration. The HHI takes into account the market share of *each* firm in an industry. The HHI has since gained wide acceptance as the public and private sector standard for measuring market concentration and assessing the competitiveness of markets.

The HHI is calculated by squaring the percentage market share of each firm in the industry and then adding those squares. For example, in an industry with only 3 firms, the HHI would be calculated as follows: HHI = (market share of firm $1)^2$ + (market share of firm $2)^2$ + (market share of firm $3)^2$. In an industry consisting of 100 firms, each with an equal share of the market, the HHI would equal 100. In an industry with one firm, a pure monopoly, the HHI would equal 10,000 (or 100^2). Thus, the index is smaller the more firms there are in the industry and the more equitable the distribution of market shares between firms. In general, markets with an HHI of 1,000 or less are considered relatively unconcentrated, whereas markets with an HHI of 1,800 or greater are considered highly concentrated. (If an industry has an HHI value between 1,000 and 1,800, the Justice Department will challenge any merger that increases the HHI by at least 100 points).

[19] "Financial and Market Conditions," Insurance Information Institute (August 2011) (http://www.iii.org/issues_updates/financial-and-market-conditions.html).

[20] Best's Aggregates & Averages, Property/Casualty, United States & Canada (2011 edition).

[21] Financial Stability Oversight Council 2011 Report for Congress (July 22, 2011) ("FSOC Annual Report"), available at http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf. Specifically, the FSOC Annual Report provided the following conclusions with respect to insurance business and investments:"A key role of financial

DISCUSSION & EXAMPLES

Due to the stable nature of the industry, one might be tempted to conclude that there is no need to modernize the U.S. insurance regulatory system. Yet, such a conclusion would ignore the realities of a state-based regulatory structure along with how that structure has evolved in certain respects. In order to illustrate the need for reform, AIA has set forth below some specific examples where regulation has impeded the benefits of private market competition and is actually harming consumers in the marketplace. While by no means exhaustive, we hope that these examples provide the opportunity for further FIO engagement and public debate and discussion. The examples are not intended to denigrate hard-working, well-intentioned state regulators because, in many instances, local political and environmental conditions influenced the policy direction.[22]

AN EFFECTIVE INSURANCE REGULATORY SYSTEM PROTECTS CONSUMERS BY PROMOTING FINANCIAL SOLVENCY AND AVOIDING THOSE AREAS OF REGULATION THAT DETRACT FROM SOLVENCY

"The purpose of insurance regulation, stated classically, is to protect consumers by monitoring the solvency of insurers and their business practices."[23] If the effectiveness of regulation is judged by these twin consumer protections, any effort to improve the system should identify regulations that detract from those objectives. Florida's struggle with property insurance regulation, the ebb and flow of automobile insurance rate regulation in certain states, and our

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markets and institutions is to allocate risk efficiently across households and businesses. The insurance market is a key market in financial risk transfer. Unlike most cases of credit intermediation, in which borrowers receive a large payment at the start and then repay the obligation over time, insurance policies typically involve upfront customer payments (premiums) in exchange for a contractual promise from the insurer to pay benefits upon a specified event in the future. *The traditional U.S. insurance market largely functioned without disruption in payments to consumers throughout the financial crisis and the recovery.*" (emphasis supplied) (p. 24)

"The insurance industry is an important source of long-term funding to the economy through its investment of premium income. *Insurance companies, with some notable exceptions, generally withstood the financial crisis and have since strengthened their balance sheets.* Their investment portfolios have improved along with general financial market conditions. The segment of the industry that provided financial guarantees on mortgages and mortgage-related assets experienced severe difficulties." (emphasis supplied) (p. 61).

[22]A number of the examples are drawn from multi-jurisdiction compliance surveys that AIA prepares for its members. Those surveys set forth the state-by state standards in a wide variety of areas, including personal and commercial lines rate and policy form requirements, restrictions on defense within limits provisions in commercial lines policies, punitive damage exclusions in automobile policies, and standard fire policy terrorism exclusions. Should the FIO want any more detail on examples set forth here or in other aspects of insurance regulation, please contact us directly.

[23]CRS Report on Insurance Regulation at CRS-2.

members' experience with policy form requirements, amply illustrate the ways in which regulation can create risk, rather than reducing it.

Florida Property Insurance

Florida's enormous coastal hurricane exposure,[24] coupled with a fast-growing population and land-use and tax policies geared toward property development, have generated enormous property insurance challenges in the state. Regulatory controls and restrictions adopted by the Florida legislature in 2007 have largely served to increase public exposure to natural catastrophe losses, rather than reduce such exposure or engender a more functional private market environment.[25]

Following catastrophic losses and insolvency concerns in the wake of Hurricane Andrew, legislation was enacted to create the Florida Residential & Casualty Joint Underwriting Association ("JUA"),[26] expand the Florida Windstorm Underwriting Association ("FWUA"),[27] and establish the Florida Hurricane Catastrophe Fund ("Cat Fund").[28] The first two efforts – the JUA and an expanded FWUA – were residual markets intended to provide consumers with a near-term safety valve that would provide property insurance for those unable to purchase coverage privately, as well as a long-term safety net. The Cat Fund is a government program from which private insurers must purchase government reinsurance for a substantial portion of their catastrophic hurricane exposures regardless of whether those insurers already have reinsurance.[29] The cost for Cat Fund reinsurance is less than the private market, as a means of maintaining insurance capacity in the state.[30] While in theory there is nothing wrong with establishing similar government mechanisms to address private market dysfunction due to catastrophic risk of loss, their political evolution has only exacerbated potential public exposure

[24] Though it has certainly grown, total coastal insured value was $2.5 trillion in 2008. *See Granularity in the Florida Property Insurance Market* at 5, Florida Catastrophic Storm Risk Management Center, FLORIDA STATE UNIVERSITY, http://www.stormrisk.org/admin/downloads/Granularity%20in%20the%20Florida%20Property%20Insurance%20Market%208-09.pdf. Seventy-nine percent of the state's insured value consists of coastal exposure. *Id.* (citing AIR Worldwide, 2008).

[25] Stronger building codes also have been adopted in the state. 1998 Fla. Sess. Law Serv. Ch. 98-287; 2000 Fla. Sess. Law Serv. Ch. 2000-141. While that has helped to strengthen new construction against future storms, it has not done anything to slow down the pace of such construction in exposed areas.

[26] The former JUA was created by act of the Florida Legislature in December 1992 (Florida Stat. Ann. §627.351(6)).

[27] The former FWUA was created by act of the Florida Legislature in 1970 (Florida Stat. Ann. §627.351(2)).

[28] The Cat Fund was created by act of the Florida Legislature in November 1993 (Florida Stat. Ann. §215.555).

[29] Florida Stat. Ann. §215.555.

[30] *Id.*

without facilitating solutions. Several "reforms" were a legislative response to bad storm years. In 1997, the legislature increased the ability of these entities to charge assessments unilaterally, while also increasing their capacity to write insurance.[31] Five years later, the legislature combined the JUA and the Windstorm Underwriting Association to form the Citizens Property Insurance Corporation ("Citizens") as a state authorized and run property insurer.[32]

In 2005, following a particularly heavy 2004 storm season, the legislature adopted another series of reforms, including: (a) creation of a hurricane loss mitigation program, (b) mandatory offer of seasonal deductible policies to consumers, (c) reduction in size of the Cat Fund, and (d) permission for Citizens to compete with private property insurers in the Florida Keys.[33]

The 2007 reforms,[34] in contrast, were a political response to a storm of public protest following rate increases and insurance company profits[35] during the relatively mild storm season preceding those legislative actions. Instead of a balanced proposal aimed at growing the private market, the bill enacted by the legislature in the wake of Governor Crist's election called for numerous provisions aimed squarely at containing rates without regard to the risk of loss. With respect to Citizens, the legislation made numerous changes designed to make Citizens a state-created market competitor rather than a market of last resort, including: (a) repeal of the requirements that Citizens rates be non-competitive and that they include a catastrophe loading factor;[36] (b) a rate rollback on Citizens' January 2007 increases;[37] (b) a two-year rate freeze for Citizens;[38] (c) an elimination of Citizens' 1-in-100 year storm reserve requirement; (d) a trigger allowing Citizens the right to sell property insurance to any Florida resident quoted a rate 25% higher than Citizens' rate;[39] (e) a repeal of the requirement that Citizens purchase

[31] 1997 Fla. Sess. Law Serv. Ch. 97-55.

[32] 2002 Fla. Sess. Law Serv. Ch. 2002-240.

[33] 2005 Fla. Sess. Law Serv. Ch. 2005-111.

[34] Florida Enrolled CS/HB 1A (2007).

[35] While it is true that insurers had some return to profitability in the mid-2000s, it is important to remember that insurers had a lost decade in Florida after Hurricane Andrew. *See* Insurance Information Institute, "Florida's Insurance Markets: An Overview," p. 3 (Sept. 2010) ("Florida's property insurers have been operating in the red on a cumulative basis since Hurricane Andrew struck in 1992. It took 11 years for insurers to break even after the losses paid out from Hurricane Andrew. Companies returned to profitability in 2003, and then slid back into the red with back-to-back hurricanes in back-to-back years (2004, 2005)." Indeed, "19 percent of all U.S. insured losses from 1980 -2006 impacted the state." *Id.* at 2.

[36] Florida Enrolled CS/HB 1A *at* § 21.

[37] *Id.*

[38] *Id.*

[39] *Id.*

private reinsurance; (f) expansion of the Citizens assessment base;[40] and (g) provisions that made it easier for policyholders who had left Citizens to return, as well as language allowing consumers that were accepted by Citizens to obtain immediate coverage. In particular, the expansion of Citizens' ability to write policies for any consumer that received a quote over 25% above the Citizen's rate created a *de facto* rate ceiling for all property insurers operating in the state.

Other legislative provisions: (a) expanded the Cat Fund for all insurers, allowed very small insurers to purchase even more reinsurance from the Fund, and mandated a rate rollback (reduction in insurance rates) to reflect the availability of this additional coverage from the Cat Fund (even if an insurer chose not to buy the additional coverage);[41] (b) established a tax on so-called "excess" profits of insurers;[42] (c) created "lock-in" features requiring Florida auto insurers to also write homeowners' insurance if they wrote that line anywhere else in the country;[43] and (d) mandated a claims decision within 90 days of receiving notice of the claim.[44]

Also noteworthy in the 2007 legislation (HB 1A) was the adoption of an expanded mandate that insurers provide catastrophic ground cover collapse or "sinkhole" coverage.[45] Not surprisingly, within two years of the expanded sinkhole mandate, which included substantial new investigatory costs and obligations for insurers, the cost of sinkhole claims doubled from $209 million before passage to $406 million two years after passage.[46] The uptick in claims and their cost along with widespread allegations of fraud and misbehavior was so profound that the legislature substantially reformed the sinkhole law this past spring, only 4 years after its original passage.[47]

Enactment of these provisions had the comprehensive impact of increasing the debt ceiling and leverage of Citizens and the Cat Fund, while encouraging their growth and not permitting rate

[40] *Id.*

[41] Florida Stat. Ann. § 215.555(4), (16) & (17)

[42] Florida Enrolled CS/HB 1A (2007), § 26.

[43] *Id.*, § 42 ("Effective January 1, 2008, no insurer writing homeowners' insurance in another state, but not in Florida may continue to write private passenger automobile insurance in Florida unless the private passenger automobile insurer is affiliated with an insurer writing homeowner's insurance in Florida.").

[44] Florida Stat. Ann. § 627.70131.

[45] Florida Stat. Ann. § 627.706.

[46] Florida Office of Insurance Regulation, *Report on Review of the 2010 Sinkhole Data Call*, at 5 (November 8 , 2010) (http://www.floir.com/siteDocuments/Sinkholes/2010_Sinkhole_Data_Call_Report.pdf).

[47] Florida Senate Bill 408.

increases or other prudent financial measures needed to offset the growth in exposure. Insurance exposures and losses were not reduced by these legislative changes, which instead were focused on reducing the upfront price of property insurance.[48]

At the same time, the legislation effectively capped the ability of private insurers to compete on price, while adding restrictions on their claims and other business practices. "Property insurance rates actually dropped between 2007 and 2009, due to state-mandated discounts ... Reductions were mandated despite evidence that current rates were not adequate to cover anticipated claims. This additional loss in premium income prompted many insurers to lose money even without a major hurricane striking the state, and they responded by further curtailing their business."[49] An Insurance Information Institute Report documenting these trends also indicates that the Office of Insurance Regulation ("OIR") has started to reverse course, and to review insurer financial data in light of rising claims costs. However, just as a rapid rise in insurance rates preceded the 2007 reforms, it would not be wise to assume that the OIR will allow rate increases that would bring insurance charges in line with the property risk.

To add insult to injury, the 2007 legislation did not curb the unilateral assessment authority for Citizens or the Cat Fund, ensuring that exposure to catastrophic hurricane losses in Florida would not be limited, but could possibly affect all Florida policyholders and insurers.[50] In fact, by not reducing insurance exposures or losses, the 2007 legislation dramatically increased the reliance of the market on post-event bonds issued by Citizens and the Cat Fund in order to fund losses, a situation that became absolutely untenable when bond markets suffered a near collapse in 2008. In a classic "pay me now or pay me later" scenario, the State of Florida chose to pay for losses after the fact, undermining the very fundamentals of the insurance risk transfer mechanism in order to achieve temporarily lower upfront premiums.

The rise in the number of Florida property insurers entering the market does not provide any comfort either. Aon Benfield summarized the Florida property market dynamics at the end of 2009:

- "Approximately 75 percent of Florida HO premium is written by insurers with an A.M. Best rating lower than "A-" or by those that are unrated. Citizens ... has a market share

[48] Insurance Information Institute, "Florida's Insurance Markets: An Overview," pp. 3-4 (Sept. 2010).

[49] *Id.* at 4.

[50] *Id.* at 3 ("Citizens does not collect enough premium to pay the claims that would result from a major storm, and when it runs out of money, it assesses its policyholders and all other Floridians, even those with insurance in the private market, including auto insurance policies.").

of more than 14 percent, which adds materially to the State's exposure to insured catastrophes.[51] The State's exposure also includes $23.2 billion of projected capacity from its [Cat Fund]. Even with the State's catastrophe leverage high, it is difficult for Citizens to gain the rates it says it needs. In an October rate filing hearing, Citizens indicated a 40 percent rate increase is necessary to make rates actuarially sound. In November, a 5.3 percent average rate increase was approved by regulators."

- "Despite operating in the world's peak catastrophe market, most Florida-based HO insurers are capitalized at lower levels than their non-Florida peers, as measured by NAIC's risk-based capital (RBC) ratio."[52]

In the ensuing two years, the situation in Florida has gone from bad to worse. In the 21 months ending in September, Citizens' policies-in-force increased 42% to 1.46 million.[53] Indeed, since January 1, 2011, the Citizens policy-in-force count grew over 14% to 1,482,707, with over ***$515 billion*** in exposure.[54] According to AM Best data, Citizens is the largest homeowners insurer and largest total property insurer in the state with over 16% of the homeowners market and 17.5% of the entire property insurance market in Florida.[55]

Hallmarks of this state-based property insurance regime are post-event assessments.[56] Citizens, the Cat Fund and the Florida Insurance Guaranty Association all rely upon them to cover funding shortfalls by assessing policyholders and often across broad ranges of coverage that are not property insurance by nature, including auto and liability insurance. These

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[51] "Florida's state-run insurer has increased its total exposure to loss by 163 percent since 2002 – to $406 billion in 2009." *Id.* at 4.

[52] Aon Benfield Analytics, "Florida Homeowners Market...At the Tipping Point?" p. 2 (Dec. 2009).

[53] http://www.propertycasualty360.com/2011/10/13/floridas-citizens-property-insurance-corp-board-ra

[54] *Id.*; https://www.citizensfla.com/about/corpfinancials.cfm

[55] AM Best data is for the last full year available—2010. Given its growth this year, we expect Citizens to be an even bigger market participant.

[56] Newman, *Residual Market Subsidies in Florida Property Insurance Market: A Conceptual and Historical Framework* at 8, Florida Catastrophic Storm Risk Management Center, FLORIDA STATE UNIVERSITY, http://www.stormrisk.org/admin/downloads/Residential%20Market%20Subsidies%20in%20Florida's%20Property%20Insurance%20Market%2007-09.pdf As Newman notes:

> "Florida has followed the traditional approach of recovering residual market deficits by imposing identical percentage assessments on full policy premiums of insurance companies and policyholders. This approach may be acceptable for lines of insurance with minimal catastrophic loss exposure because rates for these lines of insurance can be set with reasonable accuracy based on accepted actuarial principles and historical experience that ordinarily does not vary significantly from year to year." *Id.* at 8.

assessments are *post hoc* liquidity meant to account for reserve and rating inadequacies and to spread those inadequacies more broadly among Floridians. In this way, Florida's state-based approach is the antithesis of customary insurance based upon the "inverted cycle of production" model discussed earlier.

Moreover, this after-the-fact assessment process results in substantial cross-subsidization by non-coastal Floridians of coastal risks. In this way, the Florida approach again defies customary insurance principles. As James Newman, of the Florida Catastrophic Storm Risk Management Center at Florida State University, put it:

> "The Florida Legislature may not have intended the deficit assessment processes set forth in Florida Statutes for Citizens, FHCF and FIGA to produce sizeable subsidies from policyholders in some parts of the state to residential property insurance policyholders in parts of the state with higher hurricane exposure; however, this is the result of the current statutory assessment procedures."[57]

In its report to the Florida Cabinet in April 2010, Citizens anticipated what assessments may be needed for a variety of storm scenarios—a 1-in-50 year storm would require nearly $3 billion in assessments, while a 1-in-100 year storm would require nearly $11 billion in assessments. [58] Moreover, the Cat Fund recently announced it could have a $3.2 billion deficit next year.[59] It is fair to say that Florida's property insurance market is "challenging."

To summarize, the Florida property insurance market situation has produced a vicious circle where financial solvency of private market insurers has been stressed by rate regulation and other related regulatory constraints while the legislature has further empowered government-run insurance mechanisms that rely on post-event funding to finance catastrophic losses. Because the mechanisms collectively siphon away customers from the private market, yet assess that same market to pay for unfunded losses, Florida has instituted a regulatory apparatus that increases public exposure and cross-subsidization while eroding competitive private markets or ensuring the financial instability of those that write there. This government-centric approach adopted by Florida to spare its residents needed, transparent insurance rate

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[57] *Id.*

[58] *Florida's Insurance Markets: An Overview* at 5, Insurance Information Institute (September 2010). "A 1-in-100 year storm means there is a one percent chance that an event can occur in any given year, comparable to a major Category 4 hurricane." *Id.*

[59] Report Prepared for the Florida Hurricane Catastrophe Fund: Claims Paying Capacity at 9 (http://www.sbafla.com/fhcf/LinkClick.aspx?fileticket=Pwe5xlr5kmc%3d&tabid=991&mid=3404) "This estimate results in an initial season 12 month funding shortfall of approximately $3.2 billion."

increases in the short-term will almost certainly prove to be a regulatory catastrophe in the long-term.

Auto Insurance Rate Regulation

Rate regulation, whether in its most intrusive form of "prior approval" or in the less intrusive forms of "use and file" or "file and use" rate regulatory systems, is in place in most states for auto insurance and allows state governments to determine market prices, often in a politically charged environment. Regardless of how it is defined, this extensive regulatory authority is virtually unknown throughout the rest of the world for insurance and has largely disappeared in the U.S. economy for other sectors. Repeated efforts to reform or limit this authority on a national level through existing structures, including the NAIC, have not produced positive results, with some exceptions in individual states that are discussed below.

The authority of government to set prices does not always result in market crises, but it always carries the risk of creating a toxic regulatory environment when other factors, such as rising costs, create the political impetus to use it to suppress rates over-all or for some elements of the population. The U.S. experience with these rate regulatory systems demonstrates they do not provide consumer value and instead can lead to decreased competition and consumer choice, large residual market populations, higher or more volatile rate levels than would occur under free market competition, and in the worst case, market failures.

Three states, South Carolina, New Jersey and Massachusetts serve as good examples of both the inherent dangers of government rate regulation, and the consumer benefits when even modest pro-competitive reforms are introduced. Meanwhile, California, with a voter initiative-installed prior approval rate regulatory system has similar problems, but it has so far been unable to reform itself because of the super-legislative majorities required to modernize its regulatory system.

South Carolina

For decades, South Carolina maintained a rigid prior approval system and suffered from high prices and a bloated residual market that covered 42% of the state's drivers. Companies also were exiting the market, with the number of insurance companies dropping from 80 in 1990 to 55 in 1996.[60]

In 1997, the legislature responded to the crisis by enacting a law that, among other reforms, replaced state-mandated risk classifications and rating territories with insurers being allowed to

[60] Martin F. Grace, Robert W. Klein and Sharon Tennyson, "The Effects of Regulatory Reforms in the South Carolina Auto Insurance Market," presented at the American Risk and Insurance Association meetings (San Diego, 2011).

compete by using their own underwriting criteria. It also permitted insurers to reject applicants that did not meet their standards and replaced the reinsurance facility with a conventional assigned risk plan.[61] The positive results for consumers came almost immediately. By 1999, when the law took effect, the number of insurance companies doubled. Over-all rate reductions were provided by many companies and the residual market depopulated.[62]

New Jersey

The New Jersey insurance regulatory system suppressed rates below the level of risk, forced companies to take drivers who did not fit their underwriting standards, and forced huge numbers of drivers into the state residual market at unsustainable subsidized rates. The New Jersey Department of Banking and Insurance in its 2004 report described the scene before reform: " ... the New Jersey automobile insurance market was immersed in an availability crisis of epic proportions. New Jersey's 30-year history of piling regulation on top of regulation had brought us to a breaking point: carriers fed up with the restrictive over-regulation were fleeing New Jersey. Good drivers were spending weeks or months shopping for a policy. With more than 40 carriers leaving New Jersey during the last 10 years, and major carriers threatening to leave, consumers were facing an availability problem for the first time."[63]

Then-Governor McGreevey called for legislation that would "create a competitive marketplace ... and give consumers more choices, protection and empowerment."[64] The legislature responded by enacting legislation that rolled back many of the restrictive regulations and provided the companies more rating and underwriting freedom. Again, the benefits for consumers became visible almost immediately. Existing companies stayed and expanded; new companies entered the market; and the increased competition lowered rates by an estimated $86.6 million in the first year alone. Insurance Commissioner Bakke summarized the results this way: "The competitive marketplace created by the reforms is benefiting drivers, feeding a growing economy, generating more employment opportunities for agents and allowing companies to expand. We anticipate this momentum to continue, further increasing consumer options and downward pressure on rates."[65]

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[61] South Carolina Department of Consumer Affairs, "Automobile Insurance," available at http://www.scconsumer.gov/publications/insuring_automobile.htm.

[62] Todd Bauer, "Auto Insurance Reform at Hand," Augusta Chronicle (Feb. 28, 1999).

[63] "In the Driver's Seat: A Report on the Status of Auto Insurance Reform in New Jersey," New Jersey Department of Banking and Insurance (2004).

[64] *Id.*

[65] Press Release, New Jersey Department of Banking and Insurance (July 29, 2004).

The issue came up recently when current Republican Governor Chris Christie commented on New Jersey's auto insurance reforms: "I've got to give a shoutout to [Democrat] Governor McGreevey ... He did a very good job on that while he was governor and our auto insurance, while still high, is not anywhere near as high as it used to be about a decade ago. And that's because we went to market-based solutions that brought more folks in here, created more competition, and now you have lower rates."[66]

Massachusetts

Massachusetts exercised direct control over auto insurance rates through uniform underwriting and pricing mandates. It also had a very large residual market and comparatively few insurers. The state finally acted to inject some additional elements of free market pricing, called "managed competition." The Insurance Division summarized the results as follows: "Since the Patrick-Murray Administration introduced managed competition auto insurance reform two years ago, drivers in Massachusetts have saved nearly a half-billion dollars, and many were able to maximize savings by shopping around for a better premium. Since the start of managed competition in April 2008, 11 new companies have entered the marketplace, bringing more choice to consumers and offering better rates for better drivers."[67]

In summary, prior to reforms, each of these states engaged in intrusive rate regulation that resulted in fewer companies, high prices and large residual markets. In each case, these conditions and the related market disruptions continued for decades before the political will was mustered to make the necessary changes. After even modest pro-free market reforms, consumer choice increased, prices were reduced and residual markets shrank.

North Carolina

This state currently shares all of the hallmarks of the other states prior to pro-competitive reforms. The government effectively sets uniform prices through its approval of the base rate. Rather than the state allowing companies to charge higher prices according to risk, the state effectively forces insurers to cede many insureds to the state's residual market. The state's reinsurance facility now has 20% of the state's drivers (compared to a 0.95% national average) and accounts for 80% of the country's total residual market population. Cross-subsidies are rife and reformers estimate that competition would lower rates for 85% of the drivers.[68] Yet, the

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[66] Steve Adubato, "Gov. Chris Christie Credits Former Gov. Jim McGreevey for a Decrease in New Jersey Auto Insurance Rates," Politifact - New Jersey Star-Ledger (June 16, 2011).

[67] "Auto Insurance Premium Comparisons," Massachusetts Office of Consumer Affairs & Business Regulation.

[68] Press Release, Insurance Federation of North Carolina, (Apr. 13, 2011).

defense of this system is led by the elected commissioner, apparently immune from solvency concerns and market disruptions that this system causes.[69]

California

Proposition 103 ("Prop 103") was narrowly approved by California's voters in 1988. The Proposition was sold to the electorate as an initiative to reduce auto insurance premiums, but was drafted to cover the regulation of almost all property-casualty insurance lines, except workers' compensation.

Prop 103 replaced the state's competitive rating system with prior approval for most property-casualty insurance. In addition, it froze rates and mandated a 20% rollback. The result has been the creation of a highly-politicized, complex and intrusive state insurance regulatory system that is extremely costly for all involved and that at the same time less accurately measures and prices for risk, when compared to the regulatory systems in other states. By doing so, Prop 103 has resulted in—

- Less accurate auto insurance premiums;
- Higher than necessary costs for consumers due to a very convoluted and expensive regulatory apparatus;
- Less rapid reduction in premiums when costs are reduced, due to the extensive government intrusion into pricing; and
- False assertions by Prop 103's advocates that the overall reduction in auto insurance premiums in recent years has been the result of Prop 103, when the truth is that those reductions have been the result of other factors such as: safer cars; older and more experienced drivers; the greater use of seat belts; more vigorous law enforcement; the insurance industry's own anti-fraud efforts; and a relative reduction in overall driving miles occasioned by the recession.

As Milliman Actuary David Appel found in a 2004 report: " ... in the long run insurance rates are a function of insurance costs ... Despite the broad claims of success that are made by the proponents of state-administered pricing regulation—the key feature of Proposition 103—our analysis came to a very different conclusion about the recovery of the California auto insurance market."[70]

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[69] Insurance Federation of North Carolina, PowerPoint presentation on S.B. 477.

[70] Dr. David Appel, "Revisiting the Lingering Myths about Proposition 103: A Follow-Up Report," page 2, Milliman, Inc., Sept., 2004.

Not only did Prop 103 create an expensive, politically-charged insurance regulatory system, it loaded costs on insurers as well. Those costs are embedded in California insurance rates. For insurers that operate in many states or across the country, this means that separate regulatory management systems need to be created for one state, with all the costs and inefficiencies inherent in maintaining that separate system. Prop 103 advocates say that the big insurers can well afford to absorb these costs, but the fact is those costs ultimately are borne by consumers. Beyond their own costs, insurers are also liable for the government's own costs of operating this system. The assessments for one year, FY 2010-11, were $23, 864,234.[71]

Despite the obvious shortcomings of the system, reform in California has not occurred. That is because, unlike the other states, reform in California has been hampered by the mandate for a 2/3 super-majority in each house of the legislature in order to make any significant changes to Prop 103.

Policy Form Regulation

While it is relatively easy to measure the harm caused by rate regulation in terms of residual market size, fewer competitors, and trapped costs, the adverse consequences of policy form regulation are less obvious, but no less important. Where states deny insurance consumers the opportunity to purchase a product or delay its introduction, insurance policies become more commoditized and less responsive to innovations, which tends to harm consumers in general, but commercial insureds in particular. Insurers, in turn, are effectively discouraged from investing resources in policy development, as the enormous variation in state rules amounts to a *de facto* prohibition against selling the same policy form countrywide.

Professor Richard J. Butler, studying the impact of policy form supervision, found that commercial insurance form regulation imposes both an "approved tax" and a "never approved" tax on insurers and their commercial lines customers. In turn, this results in a flight of risk transfers from regulated insurers to less regulated and less secure alternative risk transfer mechanisms. He concluded that " ... complete deregulation of forms would increase traditional insurer market share by $18.3 billion."[72]

In many instances, the product restrictions are the result of outdated public policy or inherent suspicion of anything new. In those instances, commercial consumers in one jurisdiction that

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[71] "Proposition 103 Assessment Fee Calculation FY 2010-11 Schedule of Actual Costs vs. Actual Collections," Exhibit E, California Department of Insurance.

[72] Butler, Richard J., "Form Regulation in Commercial Insurance," in J. David Cummins, ed., *Deregulating Property-Liability Insurance* (Washington DCL American Enterprise Institute-Brookings Institution Joint Center for Regulatory Studies 2002), p. 356.

allows coverage may have an advantage over businesses in another neighboring jurisdiction that does not permit the coverage. In other cases, the repetitive filing mandates delay or discourage innovation in commercial lines. These regulatory hurdles restrict the ability of regulated insurers to timely meet the insurance needs of America's businesses, which in turn has negative implications for them and their ability to expand, hire and be globally competitive. We have outlined below several examples where policy form regulation has effectively hindered private market development.

Insurability of punitive damages

States differ in their public policy views of the insurability of punitive damages. In fact, states are almost evenly split as to whether punitive damages are insurable. Punitive damages is an area where severity far outweighs frequency, so having predictable coverage certainly lessens a commercial insured's exposure and minimizes coverage gaps that plaintiff's attorneys often try to exploit in settlement negotiations.

Of those jurisdictions that permit punitive damages to be covered, many will only allow an insurer to pay when the award of those punitive damages is the result of vicarious liability. Choice-of-law provisions in policies often come into play for corporations operating across multiple jurisdictions with varying laws. For a multi-state insured that requires such coverage, but does business in states that prohibit insurance coverage for punitive damages, it will be impossible for that insured to meet its coverage needs. For example, Missouri permits insurance policies to cover punitive damages, while Kansas prohibits that coverage.[73] If the NAIC, an entity based in Kansas City, Missouri, were a product manufacturer looking for punitive damages coverage around the country, it would be able to obtain the needed coverage in Missouri, while being foreclosed in Kansas.

Defense within Limits

States have varying limits on the types and size of policies where the form can provide for payment of defense costs within coverage limits. As a result, commercial insureds with difficult insurance risks that would benefit from greater availability of this type of coverage may practically be prevented from obtaining it in the admitted market if they do business in one of the states that either prohibit the coverage or place burdensome restrictions on it. Defense costs are a major driver of claims costs (more so than indemnity payments in certain lines), so requiring carriers to provide unlimited defense cost coverage results in either fewer carriers

[73] *Colson v. Lloyd's of London*, 435 S.W.2d 42 (Mo. Ct. App. 1968); *Hartford Acc. & Indem. Co. v. American Red Ball Transit Co., Inc.*, 938 P.2d 1281, 1293 (Kan. 1997), *cert. denied*, 118 S. Ct. 372, 139 L. Ed. 2d290.

offering complex coverages or the encouragement of unsound underwriting practices. Here are some examples of the variations in treatment of defense within limits:

- *Arkansas:* Defense within limits is only permitted where the insurer offers a separate limit equal to the annual aggregate limit of liability in the policy, but defense within limits is prohibited altogether in auto liability policies.[74]
- *Minnesota:* Bars defense within limits provisions with the exception of professional liability policies in excess of $100,000, large commercial risks and environmental impairment liability insurance.[75]
- *Montana:* Effectively bars defense within limits as within the scope of the statutory prohibition on "inconsistent, ambiguous, or misleading clauses."[76]
- *New York:* Insurance Department regulations permit defense within limits provisions only in certain circumstances and the amount of expenses that can reduce the policy limits is capped at 50% of the policy limits unless the insured is given control of its defense.[77]
- *Oregon:* Provides that liability insurance containing defense within limits provisions must be filed and approved by the Director of the Department of Consumer and Business Services.[78]
- *Vermont:* Defense within limits is not permitted in commercial multi-peril policies, but the Insurance Department will consider a separate defense limit equal to the limit of liability.[79]

[74] Ark. Code Ann. § 23-79-307(5)(A). Notably, on December 8, 2011, the Arkansas Insurance Department issued a bulletin indicating that electronic filings for package (multiple lines) filings would no longer be accepted by the Department because "the acceptance of [such] filings has resulted in the approval of some lines that are not in compliance with the defense outside the limits requirements or applicable exemption order requirements" under this provision of the Arkansas Insurance Code. Directive 3-2011, Arkansas Insurance Department (Dec. 8, 2011), "Directive on SERFF Filings Submitted Under Incorrect Type of Insurance ("TOI") Code and Subsequent Noncompliance with Defense Outside the Limits of Liability Requirements of Ark. Code Ann. § 23-79-307(5)(A) and Applicable Aid Exemption Orders (Dec. 8, 2011).

[75] Minn. Stat. § 60A.08 subdivision 13.

[76] Mont. Code Ann. § 33-1-502.

[77] N.Y. Comp. Codes R. and Regs. tit. 11, § 71.3.

[78] Or. Rev. Stat. § 742.063(1).

[79] "Rate & Forms Filing Review Requirements," Vermont Department of Banking, Insurance, Securities and Health Care Administration, available at http://www.bishca.state.vt.us/category/sections/insurance/rates-forms?page=4.

Claims-made Policies

States have many different rules for claims-made policies, which complicates product development enormously since many types of professional liability, errors and omissions and management liability (e.g., directors and officers, employment practices liability) include both claims-made and defense within limits provisions. This is also an example of outdated regulation, as many of these regulations date back to the mid-1980s when the Insurance Services Office introduced policy "simplification" and it was not yet clear which products would ultimately be sold on a claims-made basis. However, competition over the years and consumer needs have established the market for which coverages can and should be sold on a claims-made basis. New York and Maryland provide examples of difficult claims-made rules. New York requires claims-made policies to trigger coverage on a different basis than any other state.[80] Maryland requires claims-made policies to include an unlimited reporting period, which effectively turns such policies into occurrence-based policies.[81]

Uninsured/Underinsured Motorists Coverage in Automobile Policies

The staggering variation in state rules governing this coverage, which is mandatory in many states, makes compliance by insurers costly and complex in virtually all phases of an insurance transaction, including underwriting, policy issuance and claims handling. A number of states have strict rules governing mandatory offers of coverage and the acceptable methods for applicants to select or reject this coverage. These rules make consummation of automobile insurance transactions difficult and time-consuming, a particular problem when insurance customers are waiting to take delivery of a recently purchased vehicle. Numerous inconsistencies also exist between jurisdictions that impact the claim settlement process, including variations with respect to the ability to stack UM/UIM coverage on an inter-policy[82] or intra-policy[83] basis (or not at all)[84], variations on when and how coverage is triggered, and the ability, state-by-state, to offset UIM by the at-fault driver's insurance. Inconsistencies from state to state also exist with regard to when an insurer must make a UM/UIM offer on an excess/umbrella policy.[85]

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[80] N.Y. Ins. Law § 3420.

[81] Bulletin 10-36, Maryland Insurance Administration (November 3, 2010).

[82] Va. Code Ann. § 38.2-2206(B).

[83] Ind. Code § 27-7-5-5.

[84] W.Va. Code R. § 114-63-5.10.

[85] For example, Virginia law requires a UM/UIM offer be made on an excess/umbrella policy (Va. Code. Ann. § 38.2-2206), while West Virginia does require that the offer be made (W. Va. Code § 33-6-31).

Mine subsidence coverage in homeowners' policies

The mine subsidence coverage in homeowner's policies of some states underscores the variety of different ways similar coverage issues are handled in the states. All states requiring the coverage require that insurers provide mine subsidence coverage unless waived in writing. That is where the similarities end, however. In some states, the state mine subsidence fund alone sets the premiums and requires that it be separately stated on the declarations page and invoices. Other states do not have similar requirements. Some states require that the form or endorsement be approved by the state, while still others promulgate the form themselves. Still other states completely remove the insurer from the process and offer coverage for loss resulting from mine subsidence directly from the state itself.[86] Thus, while limited in nature, mine subsidence coverage demonstrates the patchwork of regulatory approaches taken by the states without any seeming coordination at all.

Group personal lines policies

States have many different rules regarding treatment of and limitations on group personal lines policies. Some states limit the lines that can be offered[87]; others place unique "front end" restrictions on the qualifications of the groups.[88] As a result, employers with employees in multiple jurisdictions that allow this coverage may be prevented from offering it as a benefit to all of their employees, if at all. It should be noted that limitations on group health insurance drove Congress to pass ERISA, taking regulatory jurisdiction over group health plans away from the states.

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[86] Illinois and Kentucky law both require separately stated premium, but neither specifies that a separate endorsement is required. (*See* 215 ILCS 5/805.1; Ky. Rev. Stat. § 304.44-030). The Kentucky fund plan of operations includes a sample waiver form, but no specific endorsement. However, the Department of Insurance webpage states that insurers must "offer a mine subsidence endorsement." Indiana requires mine subsidence coverage be "available as an additional form of coverage" and that the premium must be separately stated. (*See* Ind. Code § 27-7-9-8). Ohio requires including mine subsidence coverage on basic property and homeowners insurance in certain counties, but only requires an offer of coverage in other counties. (*See* Ohio Rev. Code Ann. § 3929.56). West Virginia requires "only those coverage forms ... which have been approved by both the Board and the Insurance Commissioner" and provides the form to be used. Insurers may reproduce the form under the name of the issuing insurance company. (*See* W. Va. Code St. R. § 115-1-3). Oklahoma does not mandate offering coverage, leaving it as voluntary "upon the request by the policyholder." (*See* Okla. Stat. 36 § 999.4). States without private insurers and only state funds include Pennsylvania, Ohio, Colorado and Wyoming. *See* www.pamsi.org (Pennsylvania's Coal and Clay Mine Subsidence Insurance Fund); www.ohiominesubsidence.com (Ohio Mine Subsidence Insurance Underwriting Association); www.mining.state.co.us/AM:Subsidence.htm (Colorado); http://deq.state.wy.us/ (Wyoming).

[87] *See, e.g.*, Ohio Admin. Code 3901-1-31.

[88] *See, e.g.*, MCLA 500.2105(2); MCLA 500.2103; MCLA 500.2403; MCLA 500.2113; Mich. Ins. Bull. 80-22; Mich. Bull. 2006-05-INS.

AN EFFICIENT REGULATORY SYSTEM VALUES UNIFORMITY AND CONSISTENCY

As many of the above policy form regulatory examples illustrate, one consequence of state-based regulation is that each state is free to make its own policy choices for its own citizens. While that may merit admiration for the states as "laboratories of democracy," the result is non-uniformity among states and inconsistent application where uniformity is achieved. Again, the regulators and state legislative organizations are not the source of blame, as both the NAIC and NCOIL has adopted numerous model laws and regulations in a variety of areas. Yet, the failure of states to actually enact many of the models is a strong silent witness to the inefficiencies of the U.S. system.

This problem is exacerbated where the federal government expresses its national intent and the states fail to act, or act in a disparate way. In recent years, Congress has attempted to accommodate two powerful interests: the continuation of state insurance regulation and the resolution of national insurance issues. These efforts began with the enactment of the Gramm-Leach-Bliley Act ("GLBA")[89] in 1999, which was the first attempt since the 1930s to modernize financial regulation. GLBA was followed by the Terrorism Risk Insurance Act of 2002 ("TRIA"),[90] which was a response to the September 11th terrorist attack on the United States. And most recently, Congress enacted the Dodd-Frank Act in 2010 as a response to the financial crisis of 2008, with the goal of establishing new regulatory mechanisms to prevent a repeat of that crisis.

While TRIA was focused solely on insurance, both GLBA and the Dodd-Frank Act centered principally on the banking and securities industries. Those laws also included insurance because insurance is an important component of the financial system. Banking and securities, however, are principally regulated by the federal government, while insurance – particularly property-casualty insurance – is regulated by the states, pursuant to the McCarran-Ferguson Act.

Thus, when there are banking or securities issues, the legislative and policy approach is straightforward: legislatively develop policy and then direct the appropriate federal agencies to carry it out. With insurance, however, the legislative and policy challenges are more complex. This complexity has arisen from the Congressional need to address national insurance problems while, at the same time, retaining an important, independent regulatory role for the states.

This has resulted in Congress trying four different approaches:

[89]Also known as "The Financial Services Modernization Act of 1999," Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999).
[90] Pub. L. 107-297 (Nov. 26, 2002).

(1) Establish a federal legal structure that partially pre-empts state law on a particular matter, but leaves most state law in place. This is what Congress did in TRIA.

(2) Establish a legal structure that describes minimum requirements for the states, but permits the states to go beyond those requirements. This is what Congress did on the GLBA privacy issues.

(3) Establish a legal structure that urges the states to undertake certain activities, but essentially leaves it up to them to carry out this federal request. This is what Congress did in GLBA with regard to the establishment of a state-based national regulatory licensing regime for agents and brokers, threatening to establish a National Association of Registered Agents and Brokers (NARAB) if the states failed to take sufficient action.

(4) Establish a legal structure that contains elements of all of these approaches, which is what Congress did in writing the Dodd-Frank Act. The Act includes some very limited pre-emption of state law in the area of international insurance negotiation on prudential insurance matters. And it urges the states to take actions with regard to surplus lines and reinsurance regulation to create elements of a state-based national regulatory system for them.

The results of these approaches to date have been mixed, but it is fair to say that none of them has provided the United States with the national uniformity that the federal legislation envisioned. While it may be too early to say that these efforts will ultimately fail to create national uniformity, it is not too early to say that most of these efforts are failing, today. The two most obvious examples are the total failure of the states to be able to come together with common standards to carry out the Congressional mandates on NARAB and the surplus lines marketplace.

The TRIA example is also discouraging. While TRIA has never been tested – and hopefully never will be tested – state resistance occurred almost immediately after initial passage in the area of rate and form regulation. TRIA expressly included a one-year preemption of state rate and form prior review or approval laws for terrorism risk insurance: "[R]ates and forms *for terrorism risk insurance covered by this title and filed with any State* shall not be subject to prior approval or a waiting period under any law of a State that would otherwise be applicable."[91] Yet, despite the plain meaning of that language, New York issued a draft circular letter opining that the TRIA preemption provision was "limited" to an "exemption" of state "prior approval of

[91] TRIA § 106(a)(2)(B).

rates and forms *intended* to provide terrorism risk insurance covered by the Act ...," and that the federal "exemption does not apply to rates and forms that exclude or limit coverage for terrorism risks...."[92] On this basis, the New York insurance department refused to permit terrorism exclusions even though commercial insureds were requesting them where they had rejected coverage made available pursuant to TRIA and TRIA clearly intended to preempt the states from interfering with the promulgation of terrorism-related policy language.

Further, the fact that certain states have continued to mandate that insurers cover terrorism-created fire losses for those customers who actively decided <u>against</u> purchasing terrorism insurance has undercut one of TRIA's principal purposes: to create a uniform national response to the terrorism threat where responsibilities are fairly shared among insurers, customers and the federal government. While numerous states have modified their statutory fire policies over the years since TRIA's enactment, others have not done so.

The GLBA privacy rules are different in one important respect: Congress clearly intended to let the states go their own way on privacy rules beyond the federal rules – but in allowing the states to go their own way, they have added costs while doing nothing noticeable to enhance privacy protection. In 2006, the 109th Congress passed the "Financial Services Regulatory Relief Act," directing 8 federal agencies to develop a model form, which may be used by financial institutions as a safe harbor for compliance with the GLBA privacy disclosure requirements.[93] The model privacy form is intended to create a clear, conspicuous and comprehensible disclosure that enables consumers to easily identify and compare the information sharing practices of various financial institutions.[94]

In 2010, the NAIC adopted the "[GLBA] Privacy Notices" bulletin incorporating the federal model disclosure. Indeed, NAIC efforts to implement a uniform model privacy notice in the states do not appear to be working. States were encouraged to adopt the model disclosure form without changes, but, of the 4 states that have adopted the form thus far (Virginia, Kentucky, Maine, and Nebraska), only Kentucky adopted the NAIC disclosure form intact. For example, Virginia identified that their laws require state-specific privacy disclosures and, therefore, amended the model form to include the state-specific information.[95] Maine recognized that they have state-specific requirements, but allow this information to be included

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[92] Draft Circ. Letter No. 25, New York State Insurance Department, – "Applicability, Guidelines and Procedures for Compliance with the Provisions of the Terrorism Risk Insurance Act of 2002; Guidelines for the Use of Limitations for Acts of Terrorism in Commercial Property/Casualty Policies", pp. 6-7 (Dec. 17, 2002).

[93] 15 U.S.C. § 6803(e).

[94] 15 U.S.C. § 6803(e) and 17 CFR 160.1 et seq.

[95] Admin. Letter 2011-06, Virginia Bureau of Insurance (July 18, 2011).

on the model form or on a separate document.[96] This lack of uniformity (through adoption of the NAIC model form) reduces the availability of a meaningful optional safe harbor for GLBA compliance that applies across state lines and business units.

The NARAB and surplus lines regulatory failures are also worthy of special note. On NARAB, Congress tried through GLBA to get the states to put a uniform agent licensing system in place. That effort – now more than a decade old - has essentially failed. Indeed, the failure is so palpable that new legislation has been introduced to supersede it.[97] This failure has not been for lack of trying, but because of the predictable difficulty in getting 50 or more separate and independent jurisdictions to agree on a common approach. Although a majority of states have enacted some sort of licensing reform, the Council of Insurance Agents and Brokers has testified that "[m]ost states retain a variety of individual requirements for licensing, and they all differ with respect to fees, fingerprinting and certifications, among other requirements. Even more problematic are the disparities among the states regarding business entity licensing ... The inefficiencies and inconsistencies that remain in producer licensing affect every insurer, every producer and every insurance consumer."[98]

The National Association of Insurance and Financial Advisers has succinctly stated the underlying problem: "It has proved to be very difficult for state regulators and their legislatures to unilaterally correct the identified deficiencies in state insurance regulation. Both practical and political realities dictate that, if identical bills are proposed in 50 state legislatures, 50 different bills will emerge from those 50 separate legislative processes. There are numerous reasons for this lack of success – lack of will, disagreements over substantive details, structural impediments, and the fact that it is simply very difficult to get 50 different jurisdictions to act in a coordinated fashion, and act quickly in a constantly changing global marketplace."[99]

Similar frustrations have been publicly aired about the inability of the state insurance regulatory system to put into place the surplus lines reforms set forth in the Dodd-Frank Act.[100] As described by the National Association of Professional Surplus Lines Offices, the Dodd-Frank

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[96] Bulletin 379, Maine Bureau of Insurance (August 3, 2011).

[97] *See* H.R. 1112, the "National Association of Registered Agents and Brokers Reform Act" ("NARAB II"), introduced by Representatives Randy Neugebauer (R-TX) and David Scott (D-GA), which would create an interstate producer licensing clearinghouse and which has been approved several times by the House Financial Services Committee.

[98] Written Statement of the Council of Insurance Agents and Brokers at a hearing of the House Financial Services Committee's Subcommittee on Insurance, pp. 12-13 (July 28, 2011).

[99] Written Statement by National Association of Insurance and Financial Advisers at a hearing of the House Financial Services Committee's Subcommittee on Insurance, p. 3 (July 28, 2011).

[100] *See* Dodd-Frank Act, §§ 511 – 542 (Subtitle B), the "Nonadmitted and Reinsurance Reform Act of 2010."

Act reforms were "passed to address the inconsistent way in which states manage their premium tax allocation and remittance schedules... For almost two decades, the National Association of Insurance Commissioners (NAIC) tried, unsuccessfully, to solve the problem through initiatives to harmonize the inconsistencies. Over time, however, the severity of this problem (has) increased ... The genesis of this problem lies in the contradictory and inconsistent state regulatory and tax laws, which make multi-state surplus lines transactions complicated, confusing, and very costly to all parties."[101] The Dodd-Frank Act reforms were designed to streamline and make more uniform the process of surplus lines regulation. However, the Act "is being implemented in many states (even as promoted by the NAIC) in such a way that they'll make things worse – not better – for surplus lines stakeholders."[102]

We cite these examples not to criticize state insurance regulation, but to point out what everyone knows to be true, even if few want to publicly acknowledge it. The state insurance regulatory system is well-suited to be the laboratory of democracy for experimenting with different approaches to state-based problems, but it is not designed to be – and never can be – the instrument of national uniformity for issues of a national or international nature, or for insurers whose business is multi-state, national or international. To the extent that we do not acknowledge this truth, we will continue to see regulatory failure and frustration. And we will continue to see individual state policy frustrating national goals and defeating the benefits of consumer choice.

U.S. COMPETITIVENESS AND THE GROWTH OF PRIVATE MARKETS SHOULD BE AN IMPORTANT REGULATORY GOAL

While a good part of AIA's submission focuses on those aspects of the U.S. regulatory system that are not effective or efficient, it is worth noting that the FIO's approach to this study should also be to view the system in the context of the global regulatory debate. Over the past three years, international financial supervisors have intensified discussions of regulatory standards and principles that may be applied to financial institutions, including property-casualty insurance companies, in the future. The global financial crisis has propelled these discussions, as regulators try to determine whether adjustments to regulation need to be made to prevent or mitigate the next crisis. These discussions, and any regulatory resolution, are complicated by different regulatory standards, philosophies, and cultures inherent in each country, as well as the different business models utilized by each financial industry.

[101] Written Statement of Letha Heaton, President, the National Association of Professional Surplus Lines Offices at hearing of the House Financial Services Committee's Subcommittee on Insurance, p. 3 (July 28, 2011).

[102] *Id* at S.

For the property-casualty insurance industry, there are 3 initiatives at the international level that are commanding attention: (1) the International Association of Insurance Supervisors ("IAIS") process for developing criteria to determine whether any insurers are global systemically important financial institutions ("G-SIFIs"); (2) the European Union's Solvency II equivalence process for third countries; and (3) the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame").

Systemic Risk Determination. The IAIS has engaged in a data collection exercise as it responds to a Financial Stability Board assignment to recommend a methodology for determining whether and which, if any, insurance companies pose a threat to the stability of the global financial system. Companies could be designated G-SIFIs and subjected to heightened prudential regulatory standards. This process is parallel to the process under Section 113 of the Dodd-Frank Act. So far however, unlike the domestic rulemaking process, the IAIS has not yet announced the criteria for G-SIFI designation, the ramifications of being designated a G-SIFI, or the impacts of the G-SIFI process on parallel national processes, such as the SIFI designation process under the Dodd-Frank Act. It is vitally important that all of the designation criteria be as uniform as possible to prevent the waste of public and private resources that would result from multiple designation procedures under differing criteria and that the IAIS criteria reflect the Dodd-Frank Act criteria, including the degree of regulation.

Solvency II Equivalence. Solvency II, the EU's new insurance regulatory system, is due to come into effect on January 1, 2013, with enforcement beginning on January 1, 2014. For companies based outside of the EU to be treated on the same basis with regard to such important matters as capital and corporate structure with European companies in the EU, the regulatory system in place where the company is based must be deemed "equivalent" to Solvency II. The significant amount of trans-Atlantic insurance commerce, the many policyholders that benefit from the coverage that results from it, and the good solvency oversight record of the U.S. insurance regulatory system, strongly support the position that the U.S. regulatory system is, and should be deemed to be, equivalent to Solvency II. In the absence of equivalence, U.S. companies would be disadvantaged and retaliation from the U.S. would not be unexpected.

Despite the obvious benefits on both sides of the Atlantic that would be derived from a U.S. equivalence determination, the standards for this determination, the process and the timing have not yet been finalized. For example, the U.S. is not in the "first wave" for equivalence findings so it could not be deemed equivalent by the start-up date for Solvency II. On the other hand, a transitional equivalence process may apply to the U.S., but the implementing measures for that process have not been finally determined. It is critical, therefore, that the U.S. be deemed equivalent.

Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). This IAIS work was intended to respond to regulatory issues raised by insurance groups doing significant business in more than one country. The ComFrame concept paper, including some specific proposed regulatory mandates and new reporting measures, was issued for consultation this summer and received significant commentary from regulators and insurer representatives, including AIA. Although intended to bring about some efficiencies in regulating internationally active insurance groups, ComFrame is perceived to have created a new layer of prescriptive regulation for the internationally active insurance groups, even as it fails to clearly designate which supervisors are responsible for which parts of it. ComFrame will undergo additional drafting and consultation. It is important that ComFrame not add undue burdens and costs to U.S. companies doing business internationally and that the global regulatory system avoids duplicative and contradictory supervision.

Consistent with our testimony before Congress this past July, we believe it is critical for the FIO to engage on these and other international initiatives to ensure that an authoritative and unified U.S. position is presented. "Congress envisioned this role for the FIO when it authorized the office 'to coordinate Federal efforts and develop Federal policy' on prudential international insurance matters, represent the U.S. before the IAIS, assist the Treasury in negotiating bi-lateral or multi-lateral insurance agreements on prudential issues, and to make recommendations to the FSOC regarding SIFI designations involving insurers."[103]

Where the system works for insurance consumers and the industry, it should be defended. However, where it does not align well with a regulatory emphasis on solvency or the growth of healthy private markets, it should be examined. Given the context and ongoing debate, AIA has prepared the attached principles for outcomes-based regulation, which represent our views on the macro-regulatory considerations under review at the international level. We further believe that the FIO should be fully empowered to engage on these issues and to represent the U.S. internationally to ensure that the U.S. insurance industry remains competitive, and that sound regulatory principles that promote market competition for the benefit of consumers are advanced.

[103] Written Statement of Leigh Ann Pusey, President, AIA, on behalf of AIA & the Financial Services Roundtable at a hearing of the House Financial Services Committee Subcommittee on Insurance, p. 9 (*quoting in part* 31 U.S.C. § 301 note – Federal Insurance Office Act of 2010 [§ 313(c)]) (July 28, 2011).

CONCLUSION

AIA appreciates the opportunity to provide input as the FIO develops its study of the state regulatory system, and we look forward to continuing to be a resource to the Office going forward.

Respectfully submitted,

J. Stephen ("Stef") Zielezienski
Senior Vice President & General Counsel
American Insurance Association

AMERICAN ACADEMY *of* ACTUARIES

Testimony of Jeffrey Schlinsog, MAAA, FSA
Chairperson, Financial Regulatory Reform Task Force
Risk Management and Financial Reporting Council
American Academy of Actuaries

Submitted for the Record

U.S. House Financial Services Subcommittee on Housing and Insurance
Hearing Entitled, "The Federal Insurance Office's Report on Modernizing Insurance Regulation"

February 4, 2014

Chairman Neugebauer, Ranking Member Capuano, and distinguished Members of the Subcommittee:

On behalf of the Financial Regulatory Reform Task Force of the American Academy of Actuaries[1] I appreciate the opportunity to provide this written testimony for your subcommittee's February 4 hearing, "The Federal Insurance Office's Report on Modernizing Insurance Regulation".

Effective regulation of insurance relies on sound risk management practices operating in concert with effective functional regulation and should emphasize the preservation of insurers' financial strength needed to fund insurance guarantees through reserve and capital requirements.

Effective and coordinated regulatory systems need to efficiently:

- Implement a process to identify emerging risks and how they might be measured.
- Assess the effectiveness of the regulatory process in mitigating systemic risk, including its need for increased resources, information, capabilities or new laws and regulations to respond to emerging trends.
- Coordinate monitoring of insurance companies who are members of systemically important financial groups.

With the relatively recent assumption by the Federal Reserve of an oversight role for insurance companies that have been designated as non-bank systemically important financial institutions

[1] The American Academy of Actuaries is 17,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policy-makers on all levels by providing leadership, objective expertise and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice and professionalism standards for actuaries in the United States.

(SIFIs) there are new regulatory factors to be considered. This oversight should be tailored to the unique facts and circumstances specific to the insurance industry. The basis for additional prudential regulation related to SIFIs with insurance affiliates should be an understanding of the specific underlying risks and business model, rather than based on a standard formula broadly applied to companies across segments of the financial services industry.

Among the significant recommendations in the Federal Insurance Office (FIO) Report is that states move forward with implementing principle-based reserving within the framework of accounting and solvency requirements. The FIO report also recommends that state-based solvency oversight and capital adequacy regimes should converge toward best practices and uniform standards. Another significant area covered by the report suggests that states should identify, adopt, and implement best practices to mitigate losses from natural catastrophes.

Actuaries work in the aforementioned areas in federal, state and international policy. The actuarial profession today regularly provides input to insurance regulators and policymakers concerning the design and implementation of regulations dealing with insurer solvency. Actuaries are uniquely qualified to identify, evaluate, categorize and quantify insurance risks. This capability is essential to insurance modernization and its attendant needs to specify financial reporting requirements for insurance contracts and insurer's solvency capital requirements.

Expertise within these regulatory functions is needed to effectively oversee, track, and remain proficient with the complexities of evolving financial services risk. It is for all of these reasons that we strongly urge the subcommittee's examination of insurance modernization include the actuarial profession, and the reason for our submission of these remarks. As we have previously provided the FIO[2], we would welcome the opportunity to provide you with the objective, non-partisan perspective of the actuarial profession in navigating the complexities of current and future insurance regulation and oversight.

I thank you for the opportunity to submit this testimony and would welcome the opportunity to discuss with the subcommittee ways in which to provide the actuarial expertise needed to accomplish these regulatory reform modernization goals.

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[2] http://www.actuary.org/pdf/finreport/Academy_FIO_response_111219.pdf

Consumer Federation of America

February 3, 2014

VIA EMAIL

The Honorable Randy Neugebauer
Chairman, Subcommittee on Housing
and Insurance
1424 Longworth HOB
Washington, DC 20515

The Honorable Michael E. Capuano
Ranking Member, Subcommittee on
Housing and Insurance
1414 Longworth HOB
Washington, DC 20515

RE: The Federal Insurance Office's Report on Modernizing Insurance Regulation

Dear Chairman Neugebauer and Ranking Member Capuano:

On Tuesday, February 4, 2014, the Subcommittee on Housing and Insurance is set to hold a hearing entitled "The Federal Insurance Office's Report on Modernizing Insurance Regulation." It is unfortunate that the Subcommittee did not include any consumer advocates on either of the witness panels, instead calling only upon the Federal Office of Insurance (FIO), one state regulator and eight representatives of the insurance industry.

Consumer Federation of America (CFA) and other consumer advocates have reviewed the FIO report and have identified several flaws and errors in the report, a number of items with which we disagree or believe require more research and discussion, some important insights, and still others that were simply overlooked. As such, we offer the following baseline concerns and comments on the report:

- The report does not show any evidence of data gathering concerning the affordability and availability of personal lines insurance products. This research was one of the key mandates from Dodd-Frank, and we were expecting FIO to have gathered and analyzed such data for a report as extensive and broad as this. In particular, the FIO should have focused on the cost and affordability of insurance for low- and middle-income consumers but appears not to have collected any data responsive to this critical concern;
- The report suggests "pilot-testing" deregulation of the insurance industry. It seems to ignore the extent to which deregulation of varying degrees has already been tested in many states and, further, doe not provide evidence that deregulation offers any benefit to consumers. Where the report makes any claim to justification for deregulation – citing the alleged competitive market in Illinois – FIO gets it wrong. Illinois has one of the highest levels of market concentration in the nation, with an HHI score for auto insurance of 1216, while the consumer protection oriented and more stringently regulated California marketplace has a markedly more competitive auto insurance market with an HHI concentration score of 753;
- The report largely ignores the existence and impact of the antitrust exemption for insurers in most states; and
- The report seems to prioritize uniformity in market regulation over consumer protection.

Chairman Neugebauer and Ranking Member Capuano
February 3, 2014
Page 2

With respect to the impact of insurance pricing practices on low- and middle-income Americans, the FIO makes some notable assessments of current industry practices, including:

- Factors like education, occupation and credit score "may be correlated with race" leading to higher prices for minorities;
- States should review whether or marital status is an appropriate factor in underwriting and rating; and
- "[S]imply because data [from data mining techniques] may be available...does not mean that any data is relevant" in setting prices.

We agree with the underlying thrust of these comments that socio-economic factors can lead to unfair discrimination in the marketplace. However, we believe that the FIO would serve its mandate more effectively by collecting data and providing Congress, the Administration and the public with a rich set of information to consider and assess, rather than by expressing its views on the various policy debates addressed in this report.

While we believe it would have been more appropriate for the Subcommittee to invite a balanced panel in order to address these issues, we hope to work with the Subcommittee to ensure that the FIO report and its continued work are reviewed and assessed fairly and in the service of the public interest. Thank you for considering our views.

Sincerely,

J. Robert Hunter

J. Robert Hunter
Director of Insurance

House Committee on Financial Services

Subcommittee on Housing and Insurance

Hearing on "The Federal Insurance Office's Report on Modernizing Insurance Regulation"

Testimony of Catherine Weatherford

President and CEO, Insured Retirement Institute

February 4, 2014

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, my name is Cathy Weatherford and I am President and CEO of the Insured Retirement Institute. I am pleased to provide our perspective on the Federal Insurance Office's Report on Modernizing Insurance Regulation. I commend you for holding this hearing, and I welcome the opportunity to address the Subcommittee.

Summary of Testimony

Consistent with our consumer–focused mission, my testimony today will address two (2) key points:

1. Consumers in America are facing a retirement income crisis, but insured retirement products can play a vital and unique role in helping them protect against the risk of outliving their assets. Federal and state regulators should provide consumers more education regarding the risk of outliving their assets and the financial strategies that can provide guaranteed lifetime income.

2. IRI strongly supports many of the recommendations set forth in the FIO Report regarding marketplace oversight, consumer protection and access to insurance, including the recommendations related to market conduct reform – specifically, the "lead state" concept and coordination among the states; annuity suitability regulation; the National Association of Registered Agents and Brokers Reform Act (NARAB II); and the Interstate Insurance Product Regulation Commission.

About IRI

As you may know, I have over 30 years of regulatory experience, including over half of that time as an elected Insurance Commissioner and Insurance Department staff in the State of Oklahoma. Prior to joining IRI, I served as CEO of the National Association of Insurance Commissioners for 12 years, where I worked with over 50 state insurance commissioners to craft important consumer protections, including

critical measures aimed at safeguarding our senior citizens. I joined IRI because my life's work is perfectly aligned with IRI's mission.

IRI exists to vigorously promote consumer confidence in the value and viability of insured retirement strategies, bringing together the interests of the industry, financial advisors and consumers under one umbrella. Our mission is to: encourage industry adherence to highest ethical principles; promote better understanding of the insured retirement value proposition; develop and promote best practice standards to improve value delivery; and to advocate before public policymakers on critical issues affecting insured retirement strategies and the consumers that rely on their guarantees.

IRI is the only national trade association that represents the entire supply chain for the insured retirement strategies industry. We have over 500 member companies, including major insurance companies like TIAA-CREF, Prudential and MetLife, banks like Wells Fargo and JPMorgan Chase, broker-dealers like Morgan Stanley, Raymond James and Edward Jones, and asset management companies like Goldman Sachs and AllianceBernstein. Our member companies represent more than 97% of annuity assets, and include the top 15 distributors ranked by assets under management. We offer education, research and advocacy resources to more than 150,000 financial advisors and more than 10,000 home office professionals affiliated with our member companies.

Our members are represented by hundreds of thousands of registered financial advisors across the country, and therefore, we bring a perspective from Main Street America to the Congress today. After my many conversations with these financial advisors, I have developed a deep level of appreciation for the long—standing relationships they have with their clients and friends—ten, twenty or even forty years. Our financial advisors consider that relationship to be a sacred trust and as such, they are intensely committed to helping their clients reach their retirement income objectives, which involves a series of the most significant financial decisions a person ever makes over a very long lifetime.

America's Retirement Income Crisis and the Role of Insured Retirement Products

The shift from defined benefit to defined contribution plans, longer life spans, and the rising costs of health care are among the challenges that will put a significant retirement savings and income burden on the shoulders of individual consumers, in particular middle-income Americans. This reality underscores the critical importance of a regulatory environment that provides consumers access to products that meet their need to protect against longevity risk. Insurance companies and their distribution partners are the only providers of guaranteed lifetime income products.

Background

Seventy-nine million Baby Boomers today face immediate and unprecedented retirement income challenges—challenges that simply did not exist in earlier generations. Individuals are living longer than those of earlier generations. Our research has shown that, between 2000 and 2010, the number of 60-64 year old Americans has increased by more than 50%, from 10.5 million to more than 16.2 million. According to the Society of Actuaries' Mortality Tables, a 65-year-old male has a 30 percent chance of living to 90, a 65-year-old female has a 42 percent chance. A couple age 65, has a 60 percent chance of one or both being alive at 90.

As the population in the US ages and more Boomers retire or approach retirement, concerns about financial preparedness remain high, according to industry reports. The combination of longer life spans and a declining birth rate mean the ratio of workers to retirees will continue to decline, increasing pressure on public and private pensions systems, and health care systems. People are living longer, and savings have to last through retirements that can span 20-30 years or more.

According to the Employee Benefits Research Institute's 2011 Retirement Confidence Survey, nearly half of the Boomers, over 35 million Americans, are "at risk" for inadequate retirement income, not having

sufficient guaranteed lifetime income. Just as concerning, nearly half (45%) of Generation X (ages 36-45) are "at risk" for inadequate retirement income. Alarmingly, our research has shown that only 51.4% of Baby Boomers and 40.7% of Generation Xers have tried to determine how much they will need to save by the time they retire.

As compared to prior generations, Boomers and Generation Xers bear more of the risk and responsibility for retirement savings and income generation. Traditional defined benefit (DB) pension plans in the private sector are increasingly being frozen or terminated; virtually all replacement and new plans are definite contribution (DC) plans, such as 401k plans. Historically low personal savings rates, coupled with general insufficiency of DC plan savings, mean many retirees will have to consider alternative sources of retirement income, such as working in retirement and tapping into home equity.

The shift from DB to DC plans has shifted much of the burden for retirement security from employers to individuals. Employees have to make decisions about whether to participate in a DC plan, how much to save, and how to invest, and at retirement, participants have to figure out how to make their nest egg last for life – while managing the risks that go along with that.

The Role of Insured Retirement Products

Annuities are the only financial instruments available today, other than social security and pensions, that guarantee a lifetime stream of income during retirement. With the proper use of annuity products and other retirement savings vehicles, retirees can be assured they will not outlive their assets and benefit significantly by having the ability to increase their current income.

Finally, in terms of demographics, according to another study, a typical annuity owner earns a middle class income or lower. The majority of annuity owners have household incomes between $20,000 and $74,999, Two out of three owners have household incomes under $75,000. Almost one half (42%) non-

qualified annuities are business owners and professionals. Almost one half (42%) of non-qualified annuities are business owners and professionals. Nineteen percent are (or were) blue collar or service workers and 12% worked in supervisory positions.

Annuities appeal to individuals of all income levels and people who don't have another retirement savings vehicle. In fact, annuity owners are overwhelmingly middle-income. Seven in 10 annuity owners had annual household incomes of less than $100,000.That is what makes annuities so versatile in an individual's retirement portfolio.

The Need for Consumer Education

Federal and state regulators should provide more consumer education and outreach relating to the current state of retirement financial readiness and the need for consumers to insure against the risk of outliving their assets. Insurance regulators in most if not all states have traditionally run very helpful consumer education programs regarding a range of financial risks consumers face, such as damage to or loss of a home or car. Most if not all states operate a Senior Health Insurance Program focused on assisting seniors with Medicare and other health insurance issues. However, more needs to be done to encourage all Americans to protect against the longevity risk they face (the risk of outliving their assets); and the potential human and economic impact resulting from the failure to do so.

The insurance industry and its distribution partners are the only industry that can protect against the risk of outliving one's assets through asset accumulation strategies and guaranteed lifetime income products. As previously discussed and as Department of Treasury officials know given their active involvement with the Department of Labor in these initiatives, the Obama Administration is working on measures to encourage consumers to focus on and obtain guaranteed lifetime income products. We encourage the Administration to complete the work on these initiatives. We also urge state regulators

and other federal regulators, including the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), to institute programs to promote consumer awareness of the need for Americans to protect against the risk of outliving their assets and the role guarantee lifetime income products can play in achieving financial security for a lifetime.

Marketplace Oversight, Consumer Protection and Access to Insured Retirement Products

The FIO report embraced several recommendations put forth by IRI In a comment letter we submitted in December 2011, including market conduction examination reforms – specifically the "lead state" concept and coordination among the states – and the creation of a national insurance licensing clearinghouse via the National Association of Registered Agents and Brokers Act (NARAB II). These reforms, if enacted, will lead to more efficient and effective regulation, ultimately reducing costs for insurance providers and Americans who rely on insured retirement strategies.

Market Conduct Examination Reform

The need for much greater market conduct regulatory efficiency and effectiveness has long been recognized by all stakeholders--regulators, legislators, industry and consumer groups have all agreed on this. Many good faith efforts have been made on this issue, starting at least 13 years ago with the first formal recognition of this need in the NAIC's Statement of Intent to Modernize Insurance Regulation. While progress has been made in some areas, too many redundant, unnecessary, and uncoordinated examinations and data calls continue to be performed year after year. This is not good for consumers, regulators, or the industry.

Many companies are subject to numerous examinations each year by different states, federal agencies and self-regulatory organizations, over ten per year in some cases. Meanwhile, other companies are rarely if ever examined. A recent survey performed by the American Council of Life Insurers (ACLI)

showed that life insurers were on average subject to over 101 total state market conduct actions over an eighteen (18) month period of time, which includes responses to each state's Market Conduct Annual Statement (MCAS).

In a comment letter we submitted to FIO in December 2011, we urged FIO to recommend that regulators adopt specific measures to achieve a rational, effective and coordinated market conduct system that protects the interests of all consumers nationwide.

We believe the key ingredient for success in creating greater market conduct effectiveness and efficiency is a single regulatory structure with clear, agreed upon procedures and processes among the states, including:

1. A commitment to using the findings of the Market Conduct Annual Statement (MCAS) to conduct target examinations, rather than comprehensive examinations, where appropriate;
2. The concept of a lead state or states, whether that be the domestic state or the domestic state along with another state or other states;
3. Coordinated interstate examinations of companies on a consolidated basis;
4. The ability of other states to participate in the coordinated examination process if they desire to do; and
5. The ability of any state to examine a company outside the coordinated process after review and consideration of the scope and findings of a previous state or federal examination within the previous three years if an imminent risk of consumer harm exists that cannot be addressed through the coordinated process.

The life insurance and annuity industry is especially suited for interstate coordinated examinations given the unique aspects of the business model and the regulatory framework under which it operates. The

core regulatory requirements under which life companies operate are more similar than any other line of business. Moreover, because unique state conditions, like weather, do not impact life insurers and because life insurers want efficient operations, life insurers design their operations one way for the entire country to the degree possible. Therefore, life insurers' business practices are, in all important respects, uniform across the country. As a result, we believe the opportunity for success in increasing efficiency and uniformity in market conduct reform is especially ripe in the life insurance and annuity industry.

Annuity Suitability Regulation

The NAIC adopted the current Suitability in Annuity Transactions Model Regulation in 2010 to set standards and procedures for suitable annuity recommendations and to require insurers to establish a system to supervise recommendations so that the insurance needs and financial objectives of consumers are appropriately addressed. Unlike prior versions, the 2010 version of the Model imposes training requirements for producers. Consistent with FIO's recommendation, IRI believes this Model Regulation should be uniformly adopted and implemented in all states.

To date, the 2010 version of this Model has been adopted in 31 states. Prior versions of the Model remain in effect in 18 states (including Florida), while one state has adopted annuity suitability regulations not based on the Model, and another state has yet to adopt any annuity suitability regulations.

National Association of Registered Agents and Brokers Reform Act (NARAB II)

The House passed a standalone version of NARAB II (H.R. 1155) in September 2013, while the Senate included this legislation in a bill related to the National Flood Insurance Program (S. 1926). These were important steps toward removing a regulatory barrier that has been impeding broker-dealers' ability

and financial advisors' willingness to sell lifetime income products. On behalf of our membership, we extend our appreciation to all the Members of Congress who have supported this commonsense legislation. With their continued support, more efficient and effective regulation is on the horizon. With both chambers on record as supporting NARAB II, there is unprecedented momentum to enact this legislation. We urge Members of the House and Senate to work together to pass NARAB II, either as a standalone bill or through some other legislation.

Interstate Insurance Product Regulation Compact

The National Association of Insurance Commissioners (NAIC) adopted the Model Interstate Insurance Product Regulation Compact Law ("IIPRC" or "Compact") in 2003. The purpose of this Model law was to address lack of uniformity and delays in consumer access to new products by creating a single set of product standards for all life and annuity products in the United States, and establishing a one-stop filing process for product approvals.

Product speed-to-market is critical as product innovation has significantly accelerated to meet the needs of the 79 million Baby Boomers entering or nearing retirement. Since 2009, insurers have submitted more than 1,100 variable annuity product filings with the SEC, which demonstrates how the industry is continually innovating to meet consumer demands and the need for product speed-to-market.

The Compact became operational in 2007, according to its provisions when state adoption reached 40% of the U.S. market. Forty-one (41) states representing approximately seventy percent (70%) of the U.S. market have adopted the Compact. California, New York, and Florida, which make up approximately twenty-five percent (25%) of the U.S. market, have not yet adopted the Compact. Illinois, the 5th most populous state in the U.S., has adopted the Compact, but has not fully implemented all annuity products standards that have been adopted by the Compact.

With regard to variable annuity products that provide guaranteed lifetime income payments for retirees, for all practical purposes, these products were able to be filed with the compact after June 2010. This is when the Compact adopted product standards for guaranteed living benefit riders, which have been sold in conjunction with over 84% of all variable annuity sales. The Compact is scheduled in the near term to begin consideration of product standards for group annuities, which are used for employee retirement plans, including plans offered to teachers and others employed by educational institutions.

While progress has been made with adoption of the Compact, our members, both insurers and distributors, continue to report substantial delays in bringing new products to market. Our insurer and distributor members, all of which operate nationwide, are concerned about the reality of not being able to offer their clients, on a timely basis, products having the best pricing or most up-to-date beneficial product features that are available to consumers in neighboring states and other parts of the country. Given the needs of those entering or nearing retirement, the importance of rapid product innovation and market deployment has never been greater.

Further, life insurers and broker dealers compete directly with other financial services institutions, such as banks and mutual funds. However, national banks do not need explicit regulatory approval to bring products to market on a nationwide basis. New banking products can be in the marketplace in a matter of days or weeks. Securities firms typically obtain regulatory approval from the Securities and Exchange Commission in a matter of 3 to 4 months. In contrast, in many cases, obtaining life insurance and annuity product approvals across the country can still take anywhere from 6 months to 2 years to complete.

The ability of insurers and distributors to offer the newest product features with current market pricing in the most expeditious manner is important to meet significant consumer needs and differing

consumer risk profiles, as well as for the competitiveness of the insurance industry and its distribution partners.

Therefore, consistent with FIO's recommendation, we believe all states should adopt the NAIC IIPRC Model Law or product standards and approval deadlines consistent with the Compact, and the Compact should complete product standards for all products. Moreover, we believe the Compact should adopt a process to consider innovative products that may not squarely fall within the current standards.

Conclusion

Thank you again for the opportunity to present this testimony. We hope you will find it useful, and we would welcome the opportunity to work with Congress and the Administration in the future as you consider additional legislative and regulatory changes to help all Americans achieve real retirement security.

SEAN MCGOVERN
Director, Risk Management
General Counsel

LLOYD'S

The Honorable Randy Neugebauer
Chairman
Subcommittee on Housing & Insurance
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Mike Capuano
Ranking Member
Subcommittee on Housing & Insurance
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

4 February 2014

Dear Chairman Neugebauer and Ranking Member Capuano:

Thank you for convening this important hearing to examine the Federal Insurance Office's recent report entitled "How to Modernize and Improve the System of Insurance Regulation in the United States" (the "FIO Modernization Report"). Lloyd's is submitting this comment letter on the FIO Modernization Report which we hope will be made part of the hearing record.

Lloyd's is the world's leading specialist insurance and reinsurance market, with 87 syndicates utilizing over 75 licenses to underwrite insurance and reinsurance in 200 countries and territories worldwide. In 2012, Lloyd's wrote premiums of $40.5 billion through 192 accredited brokers.

Lloyd's has a longstanding commitment to the US insurance market and has written insurance in the US since the 19th century. The US is Lloyd's largest market, accounting for 35% ($12.5 billion) of the insurance and reinsurance premium written by the Lloyd's market in 2012.
Lloyd's is approved to provide reinsurance in all 50 states. Lloyd's reinsurance support has played a vital role in helping the US recover from catastrophic events. The Lloyd's market paid $7.8 billion in claims following the September 11 attacks and $10.1 billion following hurricanes Katrina, Rita and Wilma in 2005.

US Credit for Reinsurance Reform

Lloyd's strongly supports the FIO Modernization Report's recommendation that, to afford nationally uniform treatment of reinsurers, the US Treasury and the US Trade Representative ("USTR") should pursue a covered agreement for reinsurance collateral requirements.

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Current regulatory requirements
As the FIO Modernization Report explains, under the current state regulatory regime, a ceding insurer in the US receives 100% credit on its financial statement to the extent that gross liabilities are transferred, or ceded, to a reinsurer based in the US. By contrast, in most US states, if the reinsurer is a non-US firm, and if it is not licenced or accredited by the regulator of the state in which it seeks to provide reinsurance, the reinsurer typically must post qualifying collateral equal to 100% of the actuarially estimated reinsurance liabilities that it has assumed from the ceding insurer in order for the ceding insurer to receive full credit. The report acknowledges that this applies "regardless of the financial strength of the foreign reinsurer or the strength of the supervisory regime in the reinsurer's home jurisdiction".[1]

These credit for reinsurance rules have been strongly and repeatedly criticised for many years by non-US reinsurers and their Governments for their unfair and discriminatory character. This issue has also been one of the focal points of extended discussion within the EU/US insurance dialogue for many years. Lloyd's and other non-US reinsurers have consistently advocated that there should be no statutory collateral required for financially strong reinsurers from jurisdictions with robust domestic regulatory systems. US reinsurers trading cross-border into the UK, and indeed the great majority of EU Member States, are not subject to any statutory collateral requirements at all.

Why reform in necessary
Lloyd's believes that modernisation of the US's reinsurance collateral rules is critical to maintaining a strong and competitive market for reinsurance in the US. Reinsurance is a commercial transaction between sophisticated parties. Its purpose is to act as a mechanism for spreading risk by diversifying it across the global markets. Reinsurers, such as Lloyd's, typically write policies relating to the risks located all around the world, and thus diversify their portfolios over time and across the product lines and geographies. This is different from the business of local insurers, who diversify their books across classes of business and amongst different policyholders, but which are subject to risk concentration limits, particularly with respect to major events with the potential to lead to multiple simultaneous claims. Large multi-state insurers can therefore benefit from pooling their risks into a global pool via reinsurance, and smaller regional insurers, who are susceptible to the potential for a major event in a key region to devastate their balance sheet, use reinsurance as a means of achieving greater stability of financial results.

Reinsurance is a vital tool in helping to significantly reduce the economic impact of catastrophic events, such as natural disasters, both on those most immediately affected and for taxpayers at large. In the US, international reinsurers typically pay around 60% of total catastrophe losses and are therefore important to both the US insurance market and to the overall US economy. By diversifying US natural catastrophe risks to global markets, the US

[1] FIO Modernization Report page 37, paragraph 2.

domestic insurance market is more likely to remain healthy and robust following even the most significant natural catastrophe losses.

By writing policies globally, reinsurers can efficiently deploy their capital for very large events, as this capital can provide protection for several regions simultaneously. The ability to hold capital centrally is fundamental to the efficiency of this business model. Local collateral requirements, like those that currently exist in the US, create capital inefficiency and cause upwards pricing pressure. In turn, this makes jurisdictions that employ local collateral requirements less appealing markets to reinsurers.

Status of existing reform efforts
Against the above background, the need to modernise credit for reinsurance in the US has long been recognised. The National Association of Insurance Commissioners ("NAIC") struggled to gain consensus on this issue for over 12 years but eventually adopted in 2011 various revisions to its Model Credit for Reinsurance Law and Regulation (the "Revised Model"). While these revisions were a step in the right direction, the Revised Model continues to discriminate against non-US reinsurers by requiring collateral and creating a number of other hurdles which reinsurers must meet before credit is allowed. The credit for reinsurance requirements reflected in the Revised Model represents a market barrier to the extent they apply different rules based on a reinsurer's domicile. In addition, such restrictions are contrary to ceding insurers' interests because they unnecessarily increase reinsurers' costs and do not help to contribute to a strong and competitive market for reinsurance in the US.

The need for a Covered Agreement
Lloyd's, and indeed many other, non-US reinsurers, have advocated for a number of years that the US should conclude a covered agreement, permitting mutual recognition of the robust reinsurance regulatory regimes existing in the EU and providing for the complete removal of all statutory reinsurance collateral requirements.

We thus warmly welcome the recommendation contained in the FIO Modernization Report that, to afford nationally uniform treatment of reinsurers, the US Treasury and the USTR should pursue a covered agreement for reinsurance collateral requirements. In our view, a covered agreement is the only way to ensure nationwide uniformity with regard to this issue. We recognise and applaud the progress that has been made in getting the Revised Model adopted in 18 States. However, for a number of reasons we are not confident that the Revised Model will result in a uniform approach to credit for reinsurance across the US. Implementation of the Revised Model is voluntary, and the NAIC has not made its adoption a condition of NAIC accreditation. Our concern is that, without this motivation, it may be years before even a majority of the states adopt the Revised Model. In addition, even in the states that have adopted it, the Revised Model has been implemented in different ways with the result that reinsurers have to meet differing standards in different states.

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We have concerns with regard to the FIO's recommendation that the covered agreement should be based on the Revised Model. This is because, as explained above, the Revised Model continues to subject non-US reinsurers from robust domestic regulatory regimes to unnecessary and expensive discriminatory rules which ultimately militates against a strong and competitive market for reinsurance in the US. However, this difference of view on the proposed detail of the covered agreement does not detract from our strong support for the FIO's recommendation that a covered agreement is desirable and should be explored and pursued by the Treasury and the USTR with the US's trading partners in the EU.

Finally, I would note, for the record, that Lloyd's and indeed a number of other EU reinsurers have encouraged the EU and Member States' Governments to respond positively to the FIO's recommendation for negotiation of a covered agreement. We hope that the Committee will endorse the FIO's recommendation and encourage the US Treasury and USTR to pursue negotiations at the earliest opportunity on a covered agreement on reinsurance regulation and the removal of statutory reinsurance collateral requirements.

Insurance Broker Licensing

Lloyd's supports the FIO Modernization Report's recommendation that the National Association of Registered Agents and Brokers Reform Act of 2013 ("NARAB") should be adopted and its implementation monitored by the FIO. This important legislation would create much needed uniformity in the area of insurance broker licensing. Insurance brokers are an essential element of Lloyd's business model as business placed through brokers represents the majority of our premiums. As the FIO Modernization Report notes, the differences in licensing requirements among the states create duplicative obligations, barriers to entering business in a particular state and are a detriment to consumers. Compliance with these varying state requirements creates unnecessary administrative and costs burdens which can be especially difficult for small and medium-sized brokers. We hope that Congress will adopt NARAB in order to streamline the licensing process for brokers and ensure nationwide uniformity in this area.

Surplus Lines

Lloyd's supports the FIO Modernization Report's recommendation that the FIO continue to monitor state progress on implementation of Subtitle B of Title V of the Dodd-Frank Act, known as the Nonadmitted and Reinsurance Reform Act of 2010 (the "NRRA"). The NRRA created a number of mandates for the regulation of surplus lines insurance. The surplus lines industry plays a vital role in the US insurance market by providing coverage for risks that admitted insurers are unwilling or unable to write. Although the NRRA has helped to improve uniformity in the regulation of surplus lines policies, there continue to be issues of inconsistency in state implementation efforts. It is important, therefore, that the FIO continue to monitor state implementation in order to determine whether the mandates of the NRRA are being properly observed by the states.

Natural Catastrophes

Lloyd's supports the FIO Modernization Report's recommendation that states should identify, adopt, and implement best practices to mitigate losses from natural catastrophes. The starting point for managing the impact of natural catastrophes must be mitigation. Government and local communities can play an important role in encouraging mitigation. Stronger, more hazard-resistant building codes and stricter zoning ordinances are the most important mitigation tools available. Financial incentives, such as government subsidies or tax benefits, for mitigation can also be important motivators. If government programs require or provide incentives for mitigation, the insurance industry is then able to add further incentive through reduced premium rates.

It is important to note that Lloyd's does not support government subsidization of insurance rates. Government programs that provide subsidized natural catastrophe insurance have historically distorted the market. For example, such programs have reduced premiums below sound actuarial levels and increased taxpayer exposure to natural catastrophes. While Lloyd's understands that there is a role for government programs which operate as a "last resort" to provide coverage to property owners in economic need, such programs must be clearly and narrowly defined and strictly enforced.

Thank you again for convening this important hearing, and we stand ready to assist the Subcommittee as you continue to examine ways to modernize the insurance regulatory system in the United States.

Yours sincerely

Sean McGovern

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NAPSLO

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Testimony of
The National Association of Professional Surplus Lines Offices

Before the
House Financial Services Committee
February 4, 2014

NAPSLO is the national trade association representing the surplus lines industry and the wholesale insurance distribution system. Since its founding in 1974, NAPSLO has become the authoritative voice of the surplus lines industry, advocating for the industry's vital role in the insurance marketplace and global economy. The surplus lines market plays an important role in providing insurance for hard-to-place, unique or high capacity (i.e., high limit) risks. Often called the "safety valve" of the insurance industry, surplus lines insurers fill the need for coverage in the marketplace by insuring those risks that are declined by the standard underwriting and pricing processes of admitted insurance carriers. With the ability to accommodate a wide variety of risks, the surplus lines market acts as an effective supplement to the admitted market.

Surplus lines insurers are able to cover unique and hard-to-place risks because, as nonadmitted insurers, they are able to react to market changes and accommodate the unique needs of insureds that are unable to obtain coverage from admitted carriers. This results in cost-effective solutions for consumers that are not "one size fits all," but are instead skillfully tailored to meet specific needs for non-standard risks.

NAPSLO's membership consists of approximately 400 brokerage member firms, 100 company member firms and 200 associate member firms, all of whom operate over 1,500 offices representing approximately 15,000 to 20,000 individual brokers, insurance company professionals, underwriters and other insurance professionals in the 50 states and the District of Columbia. NAPSLO is unique in that both surplus lines brokers and surplus lines companies are full members of the association; thus NAPSLO represents and speaks for the surplus lines wholesale marketplace. We appreciate the opportunity to submit testimony to today's hearing.

Background

NAPSLO has reviewed the Federal Insurance Office's (FIO) report "How to modernize and improve the System of Insurance Regulation in the United States" in the context of the association's long standing and unwavering support of the state based system of insurance regulation. NAPSLO is heartened that the FIO recommendations and analysis strongly supports the state based system of insurance regulation. NAPSLO is pleased with the FIO's call for enactment of the National Association of Registered Agents and Brokers, to provide a uniform and streamlined licensing process for agents and brokers nationwide, which NAPSLO and many other industry associations and state regulators through the NAIC strongly support. While the report focuses on a number of important insurance regulatory issues, NAPSLO will limit the remainder of its comments to those sections that focus on the surplus lines industry; specifically, material related to the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA) found in Section IV *Marketplace Oversight, Consumer Protection and Access to Insurance.*

In passing the NRRA, Congress sought to achieve a simpler and more efficient system of regulation and taxation of the surplus lines industry by establishing the insured's "home state" as the one and only

jurisdiction to regulate and tax surplus lines transactions. In the law, Congress also clearly expressed its intent that states establish a uniform, nationwide approach to the regulation and taxation of the surplus lines industry.

NRRA Benefits, Improvements and Reforms

Since its passage, the NRRA has produced significant benefits for the surplus lines industry. Its "home state" approach has brought efficiency, clarity and uniformity to the regulation and taxation of surplus lines insurance by creating a modern and efficient regulatory framework. Consequently, NAPSLO remains a strong supporter of the law and the reforms it mandates and wishes to express its great appreciation to Congress for enacting the NRRA and to the states for their work and significant progress in implementing the law.

While the FIO report commented briefly on the NRRA, the report only commented on the tax sharing aspect of NRRA law and its implementation. Subsequently, the report does not describe the many other benefits and improvements in the regulation and taxation of surplus lines that resulted from the NRRA. Simply and briefly, these reforms include the adoption by forty-nine states of the "home state" approach, as set forth in the NRRA, to the regulation of surplus lines transactions. Before the NRRA was enacted, surplus lines brokers and insurers were often faced with inconsistent requirements governing all aspects of the insurance placement, depending on the state where the risk was located or the state where the transaction occurred. A multi-state risk became even more complex and difficult, because each state with any portion of the underlying risk had regulatory jurisdiction over the transaction. The NRRA's "home state" approach has corrected this problem and has brought a degree of uniformity to the regulatory requirements for every surplus lines transaction in the country.

Home State Taxation—Almost There

Currently, forty-six states, representing more than 80% of nationwide surplus lines premium, now collect and retain 100% of the surplus lines premium tax paid to them as the "home state" of the insured. The January 2014 report of the U.S. Government Accountability Office, "Effects of the Nonadmitted and Reinsurance Reform Act of 2010," noted the home state provision has produced significant benefits for the surplus lines industry by reducing the need for brokers and insurers to comply with differing sets of rules, disclosures and requirements.

Unfortunately, in July 2012, six jurisdictions, Florida, Louisiana, Puerto Rico, South Dakota, Utah and Wyoming, established a tax sharing clearinghouse pursuant to the Nonadmitted Insurance Multistate Agreement (NIMA). Many industry representatives, including NAPSLO, continue to question the cost/benefit of NIMA or any similar approach to tax sharing. NAPSLO strongly believes that the cost of supporting any tax sharing system will exceed the benefits derived from the insignificant tax reallocations among participating states. Such is true for the NIMA states. Based on preliminary data from NIMA's surplus lines clearinghouse, we anticipate the 0.30% filing fee incurred by surplus lines brokers for filing through the system will likely exceed the net amount of taxes reallocated among the NIMA jurisdictions. For these reasons, NAPSLO continues to advocate for implementation of the home state tax approach nationwide. We believe the only option for complete uniformity is the home state tax approach as currently implemented in the vast majority of the states.

The FIO reported that a "compact seems no more likely than before the NRRA became law." NAPSLO agrees with this statement and believes that any efforts to perpetuate tax sharing should be abandoned in favor of home state taxation nationwide. Indeed, as former Representative Dennis Moore (D-KS),

author of the NRRA said, "the letter and spirit of the NRRA [are] to provide a simpler, uniform tax reporting and payment process."

Implementation of National Eligibility Standards—More Work Needed

Another key reformation intended by the NRRA relates to the "national standards" for eligibility of surplus lines insurers. Before the NRRA, the industry faced a plethora of inconsistent standards employed by the various states in determining whether a surplus lines insurer would be "eligible" or "listed" to insure risks under each state's surplus lines law. Consequently, brokers often found themselves frustrated and their clients confused when they discovered that a company "eligible" or "listed" in one state did not meet the "eligibility" or "listing" requirements in another state where a portion of the insured risk was located or to be performed. To solve this problem, Congress set forth, in Section 524 of the NRRA, uniform national criteria for determining the eligibility of U.S. based companies to write surplus lines insurance. The NRRA's intent was to make it easier for a nonadmitted insurer that meets the NRRA eligibility criteria to become eligible to conduct surplus lines business in all states where it wishes to write surplus lines insurance.

In response to the NRRA, several states have revised their pre-NRRA eligibility and/or "white lists" requirements. However, our work continues to ensure all states fully embrace the NRRA eligibility standards in order to achieve the full intent of the law.

Conclusion

The NAPSLO membership believes the greatest benefit of the NRRA is the efficiency brought about by home state regulation and taxation. There remains tremendous opportunity to improve uniformity in

forms, filing requirements, dates and procedures for the reporting and payment of surplus lines premium taxes. Beyond the uniformity achieved with the home state approach, NAPSLO, like the FIO, believes the NRRA affords the states an excellent opportunity to demonstrate their ability to modernize and work collaboratively to further reduce the complexity and cost of unique compliance rules and requirements across state lines. We appreciate the FIO's comments on the surplus lines industry and the NRRA report and thank you for this opportunity to provide additional perspective on the FIO's report.

NCOIL
National Conference of Insurance Legislators
...for the states

January 30, 2014

The Honorable Randy Neugebauer	The Honorable Michael Capuano
Chairman	Ranking Member
House Committee on Financial Services	House Committee on Financial Services
Housing and Insurance Subcommittee	Housing and Insurance Subcommittee
2129 Rayburn House Office Building	2129 Rayburn House Office Building
Washington, DC 20515	Washington, DC 20515

Dear Chairman Neugebauer and Ranking Member Capuano:

As President of the National Conference of Insurance Legislators (NCOIL), I am writing to you regarding the December 2013 Report by the Federal Insurance Office (FIO) entitled, *How to Modernize and Improve the System of Insurance Regulation in the United States* because it addresses many issues of critical importance to states and state policymakers. The main purposes of this letter are (1) to express NCOIL's views on the FIO report, ahead of the Subcommittee's February 4 hearing, (2) to inform the Subcommittee of steps NCOIL has taken in the wake of the FIO report, and (3) to ask for your support in guaranteeing that state policymakers have a place at the table in federal level insurance discussions.

For over 150 years, the nation's state legislators have worked collaboratively with regulators to establish a responsive and robust U.S. insurance marketplace, providing the statutory framework for insurance regulation. Following the recent financial crisis, our state-based insurance regulatory system proved itself, yet again, by protecting the American consumer and mitigating the effects of the crisis. Our state-based insurance system has many benefits. The business of insurance is often local in nature and thus lends itself well to local regulation. States are in the best position to respond to consumer complaints, and the states serve as America's "laboratories for democracy" by providing unique opportunities for market experimentation and modernization. And there currently exists numerous effective mechanisms for cooperation and uniformity among the states.

The FIO report offers some general observations and recommendations in respect to various aspects of our existing insurance regulatory structure. NCOIL is currently and will continue to fully address these recommendations as a backdrop to any dialogue which could impact our state-based system of insurance. NCOIL stands ready to work directly with Congress, the Treasury Department, and the FIO to ensure that American consumers are protected and state legislatures have a significant role in the future of insurance regulation in the U.S.

As part of a long-term NCOIL engagement on issues affecting the state-based insurance system, NCOIL has recently formed an International Issues Task Force. The mission of the Task Force is to promote understanding of the U.S. state-based insurance system in the international arena and guard the soundness of state-level consumer protection and insurer solvency laws against the potential overreach of international insurance regulatory efforts.

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In addition, NCOIL is working with our legislators to apply for membership on the Federal Insurance Advisory Commission (FACI). NCOIL legislators are deeply involved with crucial insurance decisions facing the states, such as financial solvency regulation and state accreditation, reinsurance policy, rate modernization, market conduct, speed-to-market, terrorism insurance, and surplus lines reform. NCOIL believes that a state legislator's voice on FACI would be a valuable resource in advising the FIO, while showing lawmakers—at the state and federal level—that policymaker input is important to the FIO mission. Efforts to have one or more spots for state legislators on FACI are supported beyond NCOIL by other state-based organizations.

A NCOIL Unclaimed Property Task Force has also been formed to examine and make recommendations for improvement of the NCOIL Model Unclaimed Life Insurance Benefits Act, which insures timely payment of life insurance death benefits to beneficiaries. The work of the Task Force will serve to promote consistency and uniformity in current standards, investigate the current application of state unclaimed property laws, and make recommendations as needed.

As Congress debates insurance issues moving forward, I hope that you will consider this letter as a testament to the successful aspects of state-based insurance regulation and support the hard work of state policymakers in protecting the American consumer. Thank you and NCOIL looks forward to working with the Subcommittee on these issues.

Sincerely,

Greg Wren

Rep. Greg Wren, AL
NCOIL President

Cc: The Honorable Jeb Hensarling
The Honorable Blaine Luetkemeyer
The Honorable Edward Royce
The Honorable Gary Miller
The Honorable Shelley Moore Capito
The Honorable Scott Garrett
The Honorable Lynn Westmoreland
The Honorable Sean Duffy
The Honorable Robert Hurt
The Honorable Steve Stivers
The Honorable Dennis Ross
The Honorable Spencer Bachus
The Honorable Maxine Waters
The Honorable Nydia Velázquez
The Honorable Emanuel Clever
The Honorable Wm. Lacy Clay
The Honorable Brad Sherman
The Honorable James Himes
The Honorable Carolyn McCarthy
The Honorable Kyrsten Sinema
The Honorable Joyce Beatty

ACLI
Financial Security...for Life.

Gary Hughes
Executive Vice President & General Counsel

March 14, 2014

The Honorable Ed Royce
United States House of Representatives
Washington, DC 20515

Re: Comments for the Record on NAIC Governance

Dear Mr. Royce:

Following the February 4, 2014 hearing of the Subcommittee on Housing and Insurance on the FIO Report on Modernizing Insurance Regulation, you asked panelists for their views on certain aspects of NAIC governance. The ACLI is pleased to respond to your request.

Your first question asks for our views and experiences with respect to the NAIC's Policy Statement on Open Meetings. Like many having regular interaction with the NAIC and its various groups, ACLI has experienced instances in which matters have been considered in closed session that we believe warranted consideration in an open forum. Our perspective on NAIC governance and due process, however, involves issues broader than simply open meetings.

As noted in our written statement for the hearing, the NAIC's role in what might be characterized as quasi-regulatory matters has expanded significantly over the years. Laws adopted in most states have incorporated by reference a number of NAIC manuals, handbooks and instructions (e.g., the Valuation Manual, the Accounting Practices and Procedures Manual, the Annual Statement Instructions Blanks, the Own Risk and Solvency Assessment Guidance Manual, the Financial Analysis Handbook, the Financial Condition Examiners Handbook and the Market regulation Handbook). When the NAIC makes changes to these documents, the changes essentially have the force and effect of law on insurance companies without any further action by the states. The point here is that no other state or federal bodies taking actions that have material effects on regulated enterprises do so absent predictable, formally stated and statutorily mandated administrative due process (which would include provisions relating to open meetings).

We have broached this subject with the NAIC and hope to work with it to address these due process concerns. I should add that the current state of affairs with respect to NAIC governance is in some instances not solely attributable to the NAIC. In the interests of having greater uniformity in the state-based regulatory structure, the insurance industry has over the years encouraged the NAIC with respect to most of the documents noted above. Unfortunately we did so without giving sufficient thought to the governance and due process standards that should accompany the adoption of, and amendment to, these important documents. In sum, as the NAIC's role in these quasi-regulatory areas increases, the need for significantly better governance increases as well.

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Your second question involves proposed changes to the NAIC's open meetings policy, and particularly exceptions involving changes to many of the documents we referenced above. Given our stated concerns with governance and due process relative to these documents, we agree that any contemplated amendments to the Annual and Quarterly Statement Blanks and Instructions, the Accounting Practices and Procedures Manual and similar documents should be subject to full transparency and appropriate due process.

Please let me know if I can provide you with any additional information.

Sincerely,

Gary Hughes

Gary Hughes

Rep. Royce

QUESTIONS FOR WITNESSES ON THE SECOND PANEL

1) In response to my questioning, NAIC told me, with respect to its implementation of the Policy Statement on Open Meetings, that "The policy statement applies to all meetings of NAIC committees, subcommittees, task forces, and working groups," and that "any … guidance by any NAIC committee, subcommittee, task force, or working group is taken in open session as required under the Policy Statement provided above." Given your experience, is it in your opinion true that NAIC committees, subcommittees, task forces, and working groups, such as, but not limited to, the Executive Committee, always follow the open meetings policy, which promises that "NAIC is committed to conducting its business openly"? Please provide specific examples if relevant.

2. NAIC is considering a proposed revision to its open meetings policy. While the revisions contain several changes that, if properly implemented, will lead to more transparency, they also include some new restrictions on transparency. One such restriction is the new exemption from open meetings for discussions regarding the drafting of Annual and Quarterly Statement Blanks and Instructions, the Accounting Practices and Procedures Manual, and similar materials. Please explain how these authorities are used in the state regulatory scheme, how they have been and can be a vehicle for policymaking and political decisions, and whether and how a rule that exempts discussions regarding these authorities will affect the transparency of changes to state law, and whether discussions regarding these authorities merit more or less transparency than other discussions at NAIC.

1.) No. The NAIC has failed to adhere to the letter and spirit of its open meetings policy at times. There have been instances in which meetings have been closed to the public without any indication of the rationale or basis for doing so and/or with no opportunity for public input concerning whether the decision to close the session is appropriate.

2.) IIABA welcomes any effort by the NAIC that will result in increased transparency, and we believe the proposed revisions to the NAIC open meetings policy are a step in the right direction. Our association and a number of other industry groups have encouraged the NAIC to incorporate some additional revisions and improvements into the statement, and a recently submitted joint comment letter also addressed the topics referenced in your question. Specifically, the letter noted the following:

> *"We disagree with the addition of technical guidance surrounding the Annual and Quarterly Statement Blanks and Instructions and the Accounting Practices and Procedures Manual contained in exception six. Because these authorities are incorporated by reference in most states' insurance codes, the law changes automatically throughout the country when their text changes. One of the NAIC's most influential activities is to promulgate these instructions, and it in effect acts as a national legislature in doing so. If anything, meetings where regulators discuss revisions to these items should remain open, because any revisions will almost certainly affect insurers' business operations and in some cases quite significantly."*

ANSWERS OF BOB RESTREPO TO QUESTIONS OF REPRESENTATIVE ROYCE FOR WITNESSES ON THE SECOND PANEL

1. Question: *In response to my questioning, NAIC told me, with respect to its implementation of the Policy Statement on Open Meetings, that "The policy statement applies to all meetings of NAIC committees, subcommittee, task force, and working groups" and that "any...guidance by any NAIC committee, subcommittee, task force or working group is taken in open session as required under the Policy Statement provided above". Given your experience, is it in your opinion true that NAIC committees, subcommittees, task forces, and working groups, such as, but not limited to, the Executive Committee, always follow the open meetings policy, which promises that "NAIC is committed to conducting its business openly"? Please provide specific examples if relevant.*

   Answer: PCI supports greater transparency in insurance regulation and policy-making, at the state, federal and international level. With respect to the National Association of Insurance Commissioners (NAIC), PCI supports strengthening the NAIC's open meetings policy and the NAIC is currently considering potential improvements to the policy including several PCI recommendations. However, PCI appreciates that, overall, the NAIC functions in a far more transparent manner with more opportunities for public input than many federal agencies that are increasingly involved directly in insurance regulation or that issue rules impacting insurers. Also, I referenced in my testimony the growing concern about international standard setters (such as the Financial Stability Board and International Association of Insurance Supervisors) that are largely opaque and considering further narrowing already limited access by public observers. These global entities are one step further removed from accountability with a rapidly expanding regulatory agenda. We would encourage your review of and interest in the position on transparency of our U.S. representatives to these entities.

2. Question: *NAIC is considering a proposed revision to its open meetings policy. While the revisions contain several changes that, if properly implemented, will lead to more transparency, they also include some new restrictions on transparency. One such restriction is the new exemption from open meetings for discussions regarding the drafting of Annual and Quarterly Statement Blanks and Instructions, the Accounting Practices and Procedures Manual and similar materials. Please explain how these authorities are used in the state regulatory scheme, how they have been and can be a vehicle for policymaking and political decisions, and whether and how a rule that exempts discussions regarding these authorities will affect the transparency of changes to state law, and whether discussions regarding these authorities merit more or less transparency than other discussions at NAIC.*

   Answer: The NAIC's Blanks and Statutory Accounting Principles Working Group meetings have always been open. The discussions are appropriately robust and comprehensive as needed to arrive at fully vetted statutory accounting principles, interpretations and reporting forms. PCI would oppose closing these meetings. The working group discussions between regulators and insurers ensure there is an understanding of how information needs to be reported to best provide the regulators with information that meets their needs in the most effective and understandable manner.

Council of Insurance Agents & Brokers
Responses to Questions from Rep. Royce
House Financial Services Subcommittee on Housing and Insurance
Hearing on FIO's Report on Modernizing Insurance Regulation
Feb. 2, 2014

1) In response to my questioning, NAIC told me, with respect to its implementation of the Policy Statement on Open Meetings, that "The policy statement applies to all meetings of NAIC committees, subcommittees, task forces, and working groups," and that "any ... guidance by any NAIC committee, subcommittee, task force, or working group is taken in open session as required under the Policy Statement provided above." Given your experience, is it in your opinion true that NAIC committees, subcommittees, task forces, and working groups, such as, but not limited to, the Executive Committee, always follow the open meetings policy, which promises that "NAIC is committed to conducting its business openly"? Please provide specific examples if relevant.

We have no firsthand knowledge of the NAIC intentionally violating its open meetings policy by closing meetings to the public without basis to do so. Having said that, there is a general perception that it is too easy to shut the public out of NAIC meetings, and we therefore support revision of the NAIC's open meetings policy.

2. NAIC is considering a proposed revision to its open meetings policy. While the revisions contain several changes that, if properly implemented, will lead to more transparency, they also include some new restrictions on transparency. One such restriction is the new exemption from open meetings for discussions regarding the drafting of Annual and Quarterly Statement Blanks and Instructions, the Accounting Practices and Procedures Manual, and similar materials. Please explain how these authorities are used in the state regulatory scheme, how they have been and can be a vehicle for policymaking and political decisions, and whether and how a rule that exempts discussions regarding these authorities will affect the transparency of changes to state law, and whether discussions regarding these authorities merit more or less transparency than other discussions at NAIC.

The Council has reviewed the proposed revisions to the NAIC open meetings policy. While we agree with the majority of the proposed revisions, we have concerns about the use of specific language and have joined other insurance trade associations in recommending additional areas where changes are warranted.

Specifically, we disagree with the addition of technical guidance surrounding the Annual and Quarterly Statement Blanks and Instructions and the Accounting Practices and Procedures Manual contained in exception six. Because these authorities are incorporated by reference in most states' insurance codes, the law changes automatically throughout the country when their text changes. One of the NAIC's most influential activities is to promulgate these instructions, and it in effect acts as a national legislature in doing so. If anything, meetings where regulators discuss revisions to these items should remain open, because any revisions will almost certainly affect insurers' business operations and in some cases quite significantly.

We also have other concerns with the proposed revisions, and explained these concerns to NAIC in our joint trades letter, which was submitted to the NAIC in January. Specifically:

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- Many of the exceptions remain overly broad with the use of the phrase "but not limited to." We suggest removing this phrase and replacing it with more limited qualifying language in the paragraph immediately following the ninth exception. Such language could read: "While the above exceptions do not encompass all scenarios requiring a closed meeting, they represent the overwhelming majority of such scenarios with any other exceptions deemed extraordinary circumstances."
- We are also concerned with the expansion of exception eight, since NAIC's influence in the matters in question—Federal and international issues—is only growing. This increased influence must be met with a concurrent commitment to transparency.

- On a technical level, we suggested the addition of language to explicitly indicate that only the specific portion of a meeting that includes one of the nine exceptions to the Policy should be closed. In other words, if an hour meeting includes a 15 minute discussion about a particular company, then only that portion of the hour long meeting should be closed. We suggest a requirement that NAIC staff take minutes during both open and closed meetings so that the reason for holding a closed meeting is on the record and able to be verified by an outside third-party.

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May 5, 2014

The Honorable Ed Royce
2185 Rayburn House Office Building
Washington, DC 20515

Dear Representative Royce,

Please accept my sincere apologies for the delay in my reply. Below are my responses to your questions for the record from the February 4, 2014, Subcommittee Hearing entitled "The Federal Insurance Office's Report on Modernizing Insurance Regulation. "

1) **"In response to my questioning, NAIC told me, with respect to its implementation of the Policy Statement on Open Meetings, that "The policy statement applies to all meetings of NAIC committees, subcommittees, task forces, and working groups," and that "any ... guidance by any NAIC committee, subcommittee, task force, or working group is taken in open session as required under the Policy Statement provided above." Given your experience, is it in your opinion true that NAIC committees, subcommittees, task forces, and working groups, such as, but not limited to, the Executive Committee, always follow the open meetings policy, which promises that "NAIC is committed to conducting its business openly"? Please provide specific examples if relevant."**

AIA Response: *While we have no specific examples of how the NAIC is not currently following its Policy Statement on Open Meetings, that does not mean there are not examples where the Policy is not always followed. We continue to encourage as much transparency as possible given the standard-setting nature of the NAIC.*

2) **NAIC is considering a proposed revision to its open meetings policy. While the revisions contain several changes that, if properly implemented, will lead to more transparency, they also include some new restriction on transparency. One such restriction is the new exemption for open meetings discussions regarding the drafting of Annual and Quarterly Statement Blanks and Instructions, the Accounting Practices and Procedures Manual and similar materials. Please explain how these authorities**

are used in the state regulatory scheme, how they have been and can be a vehicle for policymaking and political decisions, and whether and how a rule that exempts discussions regarding these authorities will affect the transparency of changes to state law, and whether discussions regarding these authorities merit more or less transparency than other discussions at NAIC.

AIA Response: *The term "Annual and Quarterly Statement Blanks" is the insurance industry's vernacular far the annual and quarterly financial reports that are filed with each insurer's domestic regulator. These financial reports contain the financial statements and a variety of supporting schedules and exhibits. The statements, schedules and exhibits are created by completing a comprehensive set of blank forms (i.e., "fill in the blanks"), which provide detailed information about the activities of the insurer and its financial condition. The official names of these annual and quarterly reports are, respectively, the Annual Statement and Quarterly Statement.*

The Annual and Quarterly Statements are prepared according to regulatory accounting, as specified in the Statements of Statutory Accounting Principles (SSAPs). The SSAPs are housed in the Accounting Practices and Procedures Manual (AP&P Manual), which is updated annually by the National Association of Insurance Commissioners (NAIC). The states have adopted the AP&P Manual in order to ensure uniformity of regulatory accounting standards.

The AP&P Manual contains the actual accounting statements and the interpretations under those statements. NAIC's Statutory Accounting Principles Working Group (SAPWG) develops and issues the SSAPs. The interpretations are developed and issued by NAIC's Emerging Accounting Issues Working Group (EAIWG). The SAPWG and EAIWG work closely together and typically meet together, in order to avoid inconsistencies in their respective work products.
Both the SAPWG and the EAIWG utilize extensive due process procedures to raise, vet and decide accounting issues. We have found that members of the public and the insurance community, collectively referred to as "Interested Parties" (IPs), are able to actively participate in the deliberative process of the SAPWG and EAIWG. In fact, NAIC staff and members of the SAPWG and EAIWG typically reach out to the IPs for assistance. It is our belief that the collaborative approach utilized by the SAPWG and the EAIWG has been effective and useful for both industry and regulators. Because state legislatures tend to adopt the AP&P Manual by reference, IPs believe that maintaining an open, collaborative approach is a critical element of ensuring due process before the AP&P Manual is adopted into state law.

NAIC's Blanks Working Group (BWG) develops the specific forms by which the SSAPs are reflected in the Quarterly and Annual Statements that must be filed with regulators. The development of the various forms that comprise the Annual and Quarterly "blanks" follows a process that is similar to that utilized by SAPWG and EAIWG. State legislatures also adopt the Annual and Quarterly Statements as promulgated by the NAIC.

In our opinion, the BWG process is not as disciplined as the process for developing SSAPs and interpretations. The BWG operates under certain timing constraints; since changes to the

"blanks" must be transmitted to the annual/quarterly statement software vendors in time for testing and subsequent distribution of the software for year-end reporting, the BWG has set June 30th as the deadline for approving "blanks" changes that should be included in the reports for that same year. For example, if a regulator requests a blanks change for the 2014 Annual Statement, that request must be introduced, exposed, vetted, and decided on by June 30, 2014. If the proposed request is not adopted by June 30th of a particular year, it will be considered for the next year's report.

The June 30th deadline creates opportunity for mischief, in that some state regulators may propose blanks changes that are actually policy issues that should first be decided by SAPWG and EAIWG. The pressure to "get it done" by June 30th creates a disincentive to refer otherwise policy matters to the SAPWG and the EAIWG. Closing BWG proceedings makes it difficult or impossible for the IPs to know when an accounting policy matter is being pushed through as a blanks matter.

IPs have also found that having open access to BWG proceedings allows industry experts to identify inconsistencies between a blanks proposal and the relevant statutory accounting guidance. The IPs often provide the greatest expertise regarding statutory accounting guidance and the related blanks because they work with the material on a daily basis. Closing BWG meetings actually deprives regulators of their greatest resource – industry knowledge.
Given that the states typically adopt by reference the AP&P Manual and the Annual/Quarterly Statements as promulgated by the NAIC, we believe the closing of any meeting or portion of a meeting that deals with changes to the blanks or the AP&P Manual should be extremely rare.

Sincerely,

J. Stephen 'Stef' Zielezienski
Senior Vice President and General Counsel

Rep. Ed Royce (CA-39)
Full Committee Hearing entitled: "The Federal Insurance Office's Report on Modernizing Insurance Regulation."
02.03.2014
Questions for the Record

QUESTIONS FOR COMMISSIONER LEONARDI

NAIC Open Meetings:

1) At the hearing, you did not give a direct answer to my question regarding whether NAIC follows its open meetings policy. In a written response to my previous hearing questions, NAIC told me that "The policy statement applies to all meetings of NAIC committees, subcommittees, task forces, and working groups," and that "any ... guidance by any NAIC committee, subcommittee, task force, or working group is taken in open session as required under the Policy Statement provided above." But the agendas NAIC provided document day long Executive Committee meetings which included extensive public policy discussions regarding things, for example, like a regulatory modernization plan, producer licensing, market regulation, health insurance, speed to market, and solvency modernization initiatives. Given these materials (attached), given your experience, and given the common knowledge that some NAIC committees, working groups, and task forces frequently meet in closed, regulator-to-regulator sessions to discuss development of NAIC models and other policy issues, is it in your opinion true that NAIC committees, subcommittees, task forces, and working groups, such as, but not limited to, the Executive Committee, always follow the open meetings policy, which promises that "NAIC is committed to conducting its business openly"? I ask not only to create a record but to probe whether NAIC can be counted on to follow the proposed new open meetings policy that you mentioned in your answer to my question.

My experience has been that the NAIC follows its open meetings policyand I have been outspoken in my support for adherence to that policy.

2) With respect to the proposed new open meetings policy, which was drafted by a small group of which I understand you are a member:

- Why is NAIC establishing a new exemption from open meetings for discussions regarding the drafting of Annual and Quarterly Statement Blanks and Instructions, the Accounting Practices and Procedures Manual, and similar materials?

This is not a new exemption. There has always been an exemption for consultation with NAIC staff and the addition of the examples you note above was intended to limit that exemption, not expand it.

- Are not these the discussions that most merit transparency, since when NAIC writes these authorities, they often become law in most jurisdictions through statutes that incorporate them by reference?

I agree that these discussions merit transparency and the detailed procedures in place require public notice and comment and open meetings before this type of guidance is adopted. NAIC staff is regularly called upon to create the first draft of technical guidance and we believe it makes sense for the regulators to have an opportunity to discuss those drafts with staff before they are released for public comment. I would direct your attention to the procedures in place for the Blanks Working Group and the Statutory Accounting Principles Working Group.

- Would state law allow the legislative bodies that write state insurance codes to make changes to these same statutes in closed sessions?

No changes are made to any NAIC technical guidance in closed sessions.

3) The materials provided by NAIC show that the commissioners meet for hours each year as a group in private and discuss every aspect of regulatory policy making, as well as sensitive political issues such as global warming, labor relations, and off-shoring. whether the open meetings policy is a good one, specifically whether the exemptions for commissioners' conferences, roundtables, zone retreats, etc., that appear in both the current and proposed policy, are appropriate:

- Is it appropriate for members of a policy making body who assert in a formal open meetings policy that they are committed to conducting their business openly, to be able to meet as a group and conduct extensive public policy discussions and deliberations in private?

I believe it is appropriate for us as state officials to discuss certain matters privately.

- Do you agree or disagree that the purpose of open meetings rules is to expose to public scrutiny the candid discussions and deliberations of a policy making group?

I agree.

- Would the members of a Connecticut public agency, under the Connecticut Freedom of Information Law, Sec. 1-225 and other provisions, be able to go behind closed doors and spend hours as a group discussing and deliberating regarding the most important policy questions facing that body?

Though I cannot speak for the Connecticut Freedom of Information Commission, which is the public agency responsible for administering and enforcing the provisions of the Connecticut Freedom of Information Act, to the extent the question is directed to a single-member Connecticut public agency, such as the Insurance Department, I believe the Insurance Commissioner may have nonpublic candid discussions of policy and communication among his staff and others to the extent the matter does not involve a hearing or a regulatory proceeding specified in the insurance statutes administered under Title 38a of the General Statutes. Such nonpublic discussions falling outside of the open

meetings law would generally include matters directly relating to the activities of the NAIC. Indeed, pursuant to Conn. Gen. Stat. § 38a-8(d), the Insurance Commissioner is required to maintain as confidential any confidential documents or information received from the NAIC.

4) In your Dec. 11 letter, in a section entitled "the role and responsibilities of a fiduciary," you argued that NAIC should hire a consultant to review NAIC's operations and governance. You cited the previous hiring of a consultant to review NIPR as a basis for this recommendation. Since you have been an NIPR board member since Feb. 2012, since you believe that NIPR is good precedent with respect to governance issues, and since you believe that, "if the companies we regulate had the same governance issues we have here at the NAIC, we would be outraged and 'heads would roll,'" I would like to probe the governance relationship between NIPR and NAIC. NAIC controls a majority of NIPR board seats with six commissioners and the NAIC CEO. The commissioners have fiduciary duties to both NAIC and NIPR as these companies do business with each other through a servicing agreement. With respect to relationships between NAIC and NIPR and related governance and fiduciary duty issues:

- What is the proper relationship between NAIC and NIPR?

I don't know what you mean by "proper" bnt the legal relationship is that NIPR is a Missouri Not For Profit Corporation and the NAIC is the sole member of the corporation.

- What is the proper relationship between the NAIC members of the NIPR board and NIPR?

I don't know what you mean by "proper" but six members of the NIPR Board are selected by the NAIC and are members of the NAIC.

- Have you seen the attached Rough Notes article dated April 2013?

No.

- Has the NIPR board discussed the allegations made therein?

The NIPR Board has not discussed the Rough Notes article to my knowledge.

- Have you seen the attached NAIC-Aithent contract, which was in place when you joined the NIPR board, and if you have seen it, when was the first date you became aware of its existence?

I do not recall seeing the contract.

- As an NIPR board member, were you told, either when you joined the board or at any other time, that the NAIC-Aithent contract was essentially a governing

document for NIPR since it committed NIPR to many courses and standards of conduct?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question. I am no longer on the NIPR board. I joined the board in February of 2012 and my last board meeting was December of 2013.

- From a corporate governance perspective, given that you were on the NIPR board while the NAIC-Aithent contract was still in place, was it appropriate for NAIC, as a private, non-profit company which had a contract with Aithent, a for-profit third party, to promise Aithent in exchange for consideration that NIPR, a separate non-profit company, would not lower prices below a certain amount, when NIPR was not a signatory or a party to, and thus appeared to have received no direct consideration from, the NAIC-Aithent contract?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- Was it appropriate for NAIC to have promised to Aithent that Aithent could use NIPR's intellectual property and that NIPR would indemnify Aithent for certain claims?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- How did all of these NAIC promises to Aithent regarding NIPR's conduct square with the provision in the separate NAIC-NIPR contract which requires that "Nothing in this Agreement shall be construed to constitute or appoint either party as a partner, joint venture, agent or representative of the other party for any purpose whatsoever, or to grant either party any rights or authority to assume or create any obligation or responsibility, express or implied, for or on behalf of or in the name of the other, or to bind the other in any way or manner whatsoever"?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- While you have been a board member, when NIPR pricing levels have been considered, have complete disclosures been made under the Missouri Nonprofit Corporation Law, Section 355.416, which requires disclosure of all of "the material facts of the transaction" involving a "director's interest"? Specifically, was the NIPR board told, in a formal Section 355.416 disclosure, that NAIC members, when they discussed NIPR pricing levels, had a conflict because their organization has promised, in a contract in which NAIC received substantial consideration but which NIPR was not a party to, that NIPR would keep prices above a certain level regardless of market conditions?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- Do you know if such disclosures were made to the Board in prior years, such as but not limited to discussions that led to NIPR lowering prices by 15%--exactly the limit of a price decrease allowed under the NAIC-Aithent contract?

I have no information concerning NIPR pricing decisions made when I was not on the Board.

- When NIPR publicly announced rate decreases of 15%, did it publicly disclose that NAIC, which controlled a majority of NIPR board seats, had committed in a contract with a third party vendor that NIPR was not a party or signatory to that NIPR would not lower prices more than 15%?

- If not, should it have, and should regulated entities have been made aware that the prices they were paying to a private company that they were often forced to use were set not by market forces and by the free deliberation of that non-profit company's board of directors, but instead by a contract which benefited a separate corporation, of which their regulators were members, which had promised to use its influence over the first company to keep that company's prices up to a certain level?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- When the NAIC members and employee members of the NIPR board considered NIPR pricing levels, what were **all** "the material facts"? (For example, Zakibe v. Ahrens & McCarron, Inc., 28 S.W.3d 373 (Mo. App. 2000), instructing that, "to take the transaction out of the impermissible realm of self-dealing," it "has long been established that, if a corporation contracts with or engages in a transaction with … an entity in which the … director has an office or financial interest," a "director must disclose all material facts relating to that relationship or interest and to the transaction.") Did they include only the obvious fact that NAIC such members have a general conflict because of the servicing contract between NAIC and NIPR? Or did they include the separate and specific fact that, in the NAIC-Aithent contract to which NIPR was not a signatory or party, "NAIC represents it will support, and recommend to the NIPR board of directors, that a Transaction Fee remain in effect and be assessed by NIPR for [many NIPR] transactions," and that "the price of a Transaction Fee … shall not be reduced by more than fifteen percent…."? Was this not material to the NIPR board's deliberations on pricing, particularly in light of the fact that NIPR ended up reducing prices by exactly fifteen percent?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- Are you familiar with the term "SBS revenue share," or any of its iterations, which are used in many internal NIPR financial documents but do not appear to be used in public NIPR documents? What does this term mean? Were you aware that SBS revenue sharing exceeded $5 million total and exceeded $1 million in later years?

I am not familiar with the term.

- Was the fact that NAIC was obligated to pay Aithent an amount equal to 50% of NIPR revenues in SBS states, in a contract to which NIPR was not a party or signatory to, disclosed to the NIPR board under the Missouri Nonprofit Corporation Law, Section 355.416, as a material fact whenever NIPR budgets, which include a diversion of exactly 50% of NIPR revenues in SBS states to Aithent, were discussed and/or voted on?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- The NAIC-Aithent contract requires that "NAIC shall pay a royalty ... [of] 50% of the Net Revenue received by the NAIC or NIPR." Did NAIC pay NAIC's share of this obligation with respect to NIPR's net revenue, or did NIPR?

I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- Please identify with specificity any contracts dating back to 2002, which NIPR is a signatory and party to, which mandate the practice of SBS revenue sharing, a practice which continued during your tenure on the NIPR board.

It is my understanding that the SBS revenue sharing had been terminated in 2012 just after I joined the board.

- The internal NIPR 2009 budget analysis states that "Pursuant to the January 1, 2006 agreement between the NAIC and NIPR, 50% of the SBS generated transaction revenues are paid to a third party vendor." What provision in the January 1, 2006, agreement between the NAIC and NIPR requires that NIPR pay 50% of SBS generated transaction revenues to a third party vendor? I realize that you were not on the board in 2006 or 2009, but you were on the board in 2012 during the time when SBS revenue sharing was being diverted, apparently to Aithent, so the legal bases for such diversion are relevant.

I have not seen the document this question references and I am not familiar enough with the contract terms or the course of dealing under the contract to answer this question.

- Do the amounts of money which were collected by NIPR as revenues and later paid out to Aithent as SBS revenue sharing show up in NIPR's publicly available

financial statements, as found in NIPR's public annual reports, as part of the revenue and expense lines of said financial statements? If not, why not?

I am not aware that NIPR made payments to Aithent.

- Were the price fixing and SBS revenue sharing requirements discussed herein, which substantially affected NIPR governance and operations, ever made public in NIPR's annual reports or anywhere else, and if not, why not, considering that the basic provisions of the NAIC-NIPR servicing agreement are publicly disclosed in NAIC's and NIPR's reports and budgets, and considering that *NAIC's* revenue sharing with Aithent was disclosed in NAIC's public budget documents, with no mention of *NIPR* revenue sharing with Aithent?

I am not aware that NIPR made payments to Aithent.

- Did the outside consultant mentioned in your Dec. 11 letter which reviewed NIPR governance analyze whether NAIC's influence over the NIPR board has been appropriate, and, if so, did this analysis include a review of all the issues growing out of the NAIC-Aithent contract described herein?

The outside consultant analyzed all of NIPR's business operations, including its relationship with the NAIC.

- Do you as a fiduciary to NIPR believe there should be an investigation into whether NAIC acted appropriately in binding NIPR in the NAIC-Aithent contract with respect to pricing and other issues (and whether NIPR customers were as a result overcharged and if so by how much); whether the SBS revenue sharing arrangements were mandated by any contract which NIPR was a party and signatory to and received proper consideration for; whether proper disclosures regarding the NAIC's interest in these particular subjects as a result of its contract with Aithent were made to the NIPR board whenever these particular subjects (such as NIPR pricing, NIPR intellectual property, and the NIPR budget) were discussed by the NIPR board; and, perhaps most importantly, whether before the Aithent v. NAIC lawsuit was described in Rough Notes, there was ever any public disclosure, in NIPR annual reports or anywhere else, of the content of the NAIC-Aithent contract, its price fixing provision, and its SBS revenue sharing provision which resulted in the diversion of NIPR funds to Aithent?

I don't believe an investigation is necessary.

Questions for the Record – Subcommittee on Housing and Insurance

From: Congresswoman Kyrsten Sinema

Date: Tuesday, February 4, 2014

Name: "The Federal Insurance Office's Report on Modernizing Insurance Regulation"

For Commissioner Leonardi and Director McRaith

1. The MyRA retirement account, according to the U.S. Treasury, is "designed to help savers start on a path to long-term saving and serve as a stepping stone to the broader array of retirement products available in today's marketplace." How does Treasury plan to transition workers to take that next step? What tools will Treasury provide workers to ensure that their MyRA account is a true starting point to retirement security?

As this is a program of the United States Treasury Department, I defer to Director McRaith and his colleagues at the Treasury Department to answer this question.

2. If the goal is to have the best prudential supervision, the most effective regulation of the financial services industry, does it make sense to apply bank capital standards to insurance companies? If a bank-centric capital standard is misapplied to insurers, what is the impact on the average family in Arizona insuring their financial security with a life insurance policy or annuity?

I would defer to my Arizona colleagues regarding how such an approach would impact an average family in Arizona. However, more broadly, insurance regulators including myself have serious concerns regarding the application of bank capital standards to insurance companies. Banks and Insurers have fundamentally different business models. Insurers, particularly life insurers, have long-term liabilities in the form of potential claims on insurance policies that come due when people die. While some life insurance products have cash surrender or policy loan provisions, these products, unlike banking products, are not routinely utilized as sources of cash; insurance products are still focused on the insurance benefit even when additioual features exist. Insurers invest to match these long-term liabilities with long-term assets such as fixed income instruments. Banks, on the other hand, transform short term liabilities, in the form of deposits, into longer-term assets—unlike insurers, their assets are not matched to liabilities. This mismatch between the duration of their assets and liabilities is the reason many banks and other non-insurance financial institutions suffered during the financial crisis; they were unable to fund their liabilities when they came due.

It is this difference in business model that makes the Basel III bank-like capital standards inappropriate for insurance companies. For example, under these standards, the insurer would be required to hold more capital if they maintain their current portfolio to match the longer term liabilities. Holding additional capital could increase costs to policyholders if the insurers use premium increases to fund those higher capital levels. Another option is for the insurer to invest in different types of assets, the more liquid short-term assets favored by banking requirements, to avoid the additional capital that would result from

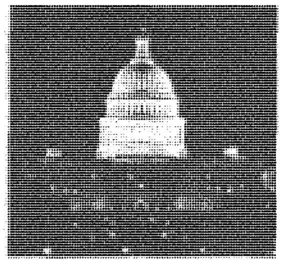
holding more appropriate long-term assets for the long-term insurance liabilities. This result could expose its policyholders to elevated levels of risk that claims will not be met since it will create an asset-liability mismatch.

3. If the Federal Reserve proposes a bank capital standard for insurance companies under its supervision, while the Arizona Department of Insurance enforces an insurance standard, what would be the implications for insurance companies in Arizona? Could we have a situation where two regulators are trying to enforce two different, incompatible standards on the same company?

Again, as the insurance commissioner for Connecticut, I cannot speak to the impact in Arizona. The Federal Reserve is the Holding Company regulator and insurance commissioners, like myself, are legal entity regulators. The capital standard the Fed imposes is a holding company standard while the capital standards state insurance regulators impose is a legal entity standard. Therefore, in cases where the holding company is the top level legal entity and the insurance company is a subsidiary, even if such standards were different, it is conceivable that both could be enforced at the same time, though it would likely a create a burden for the insurance company as described in Question 2. However, there are circumstances where the holding company is an operating insurer. In such cases, it is conceivable that the two standards could clash to some degree since they would apply to the same legal entity, and that is why it is imperative that the Federal Reserve works with state regulators as they implement these new capital standards.

4. The IRS is about to issue supplemental regulations to implement FATCA. As the regulations are currently written, non-cash value insurance would be susceptible to the FATCA regime, putting burdensome compliance on companies that place non-cash value insurance policies, which simply cannot be used for tax evasion and have nothing to do with FATCA's intent. Are you aware of this issue, and have you worked on this with staff at IRS?

I was not aware of the issue and have not worked with the staff at the IRS on the issue. I would defer to Director McRaith as his office and the IRS are both within the Treasury department and the FIO has responsibility on coordinating federal government policy relating to insurance.



The Classic NAIC operated on the largess of insurers for its first 40 years of existence ... Then the old NAII and other voices called for it to be run like a business. Boy, did they get what they wanted!

PUBLIC POLICY ANALYSIS & OPINION

By Kevin P. Hennosy

A FEDERAL CASE

Senator Nelson faces an unruly teen

When the National Association of Insurance Commissioners (NAIC) announced the retention of retired U.S. Senator Ben Nelson as its CEO on January 18, 2013, more than a few heads shook in disbelief. Nelson served as chief of NAIC staff operations from 1982 to 1985.

No one expects Nelson's second tour of duty to be mistaken for a homecoming. The "NAIC" where Nelson worked 31 years ago does not exist in place, spirit or law.

Classic vs. Newco

The NAIC that Ben Nelson worked for in the 1980s was basically a sleepy co-op, compared to the sharp-elbowed anti-competitive, corporate predator that it became under the regency of former NAIC Executive Vice President Catherine J. Weatherford and her dowager successor Therese Vaughan.

The Delaware chartered corporation doing business as the "NAIC" wraps itself in the historical significance and legal standing of an unincorporated association formed in 1871. But since 1999 that identity has vanished. It has moved from NAIC-Classic to NAIC-Newco.

The 13-year old NAIC-Newco is a very different entity. Senator Nelson has agreed to foster an unruly teen, which exhibits tendencies toward delinquency. NAIC-Newco grew up with plenty of money and a *contempt for rules.*

In the 1980s, NAIC-Classic produced videos arguing for state-based insurance regulation. Today NAIC-Newco produces YouTube videos where state officials admit making decisions to purchase products and services from the corporation without using a public bidding process required in most states. (See www.youtube.com/watch?v=23hwiHswkNQ at 2:27.)

The Classic NAIC maintained a staff facility for the cooperative benefit of all state insurance departments called the Support and Services Office (SSO). The NAIC-Newco presents a chief business strategy and development officer, who is charged with selling support and service to state offices and other customers.

NAIC-Newco expects to produce $80 million in revenue from products and services and exhibits *the unmistakable traits of a for-profit business;* however, it stubbornly claims nonprofit legal status—and it refuses to file basic financial disclosure with the IRS.

If an insurance company operated in this manner, it would eventually be the subject of a multi-state examination.

In this and further editions of *Rough Notes,* this column will examine the following issues related to the NAIC: 1) the lawsuit that the association is defending in federal court, which alleges anticompetitive activity in the NAIC's extensive profit-making operations; 2) the NAIC's actions that place its members in jeopardy of violating state ethics laws; 3) the continuing problems inherent in the NAIC's gift of travel to state officials, and 4) NAIC's tenuous claim to tax-exempt status based on misleading information submitted to the IRS. Whether Senator Nelson realises it or not, he has been left a minefield of problems.

The lawsuit

Aithent, Inc., a software development company, has filed the complaint against the corporation doing business as the NAIC (case 4-11-cv-001173-GAF).

The suit alleges NAIC's "ongoing breach of its exclusive license agreement with Aithent." In addition, the suit alleges that the agreement between NAIC and Aithent concerns "a valuable software system, developed and marketed by Aithent at great expense over the course of many years, which enabled regulatory insurance functions to be processed over the Internet."

These technological tools reduced compliance costs for the insurance sector while increasing the accuracy and efficiency of regulatory oversight.

Aithent asserts that it developed a first generation software product (LION) for use by insurance

regulators "in or around 1998." The company achieved initial success by securing contracts with the New York and Arkansas Insurance Departments.

The complaint further states that when Aithent rolled out a second generation software package (LEO), it received positive response from additional state insurance departments and then the NAIC.

The complaint alleges that the NAIC "suggested" that Aithent should enter into an exclusive licensing agreement with the NAIC rather than marketing to individual insurance departments.

The suit alleges that the NAIC and Aithent entered into the agreement, which granted an exclusive license to the former to market the latter's product to state insurance departments. In return for the license, the NAIC agreed to pay Aithent a transaction fee for every regulatory activity carried over the system.

Furthermore, the suit alleges that the NAIC "betrayed Aithent's trust," developed its own Web-based system rather than marketing LEO, and refused to pay the software company the full royalties that Aithent believes it is owed.

Court records include a copy of the license agreement signed on July 17, 2002, by then NAIC Executive Vice President Cathy Weatherford and Aithent, Inc., Chief Executive Officer N. Venu Gopal.

At the time this column was filed, the court had yet to hear the case.

The suit raises the question: Did NAIC's leadership conspire to remove Aithent from the field of competition though a contract negotiated in bad faith?

Two contracts

The contract dispute between NAIC and Aithent proves particularly interesting in the light of a contract signed by Cathy Weatherford just 55 days earlier.

On May 22, 2002, Weatherford signed a contract between the NAIC and an affiliate corporation with supposed independent standing; the National Insurance Producer Registry (NIPR), represented by then Iowa Insurance Commissioner Therese M. Vaughan, who was NAIC president at the time.

Rough Notes secured a copy of this contract.

Certainly since Weatherford signed the contract, we can assume that she read the restrictions placed upon her actions vis-à-vis NIPR by section 13 under the subhead *Status of the Parties*:

> Nothing in this Agreement shall be construed to constitute or appoint either party as a partner, joint venturer, agent or representative of the other party for any purpose whatsoever, or to grant either party any rights or authority to assume or create any obligation or responsibility, express or implied, for or on behalf of or in the name of the other, or to bind the other in any way or manner whatsoever.

A signatory to Section 13 of the May 22, 2002 contract should find it easy to interpret. Furthermore, if for some reason it just seemed too complex to comprehend, an NAIC executive vice president might ask the organization's hand-picked general counsel for an interpretation. We cannot know what went through Weatherford's mind when she affixed her name to the contract between NAIC and Aithent on July 17, 2002.

The contract with Aithent that Weatherford signed on behalf of the NAIC contains numerous and material provisions concerning NIPR. For example, Section 3b of the July 17 contract provides: "For avoidance of doubt, Aithent shall have a right of first refusal to design, create and implement all modifications to [State Based Systems or 'SBS'] as may be contemplated by the NAIC or its affiliate [NIPR]."

In addition, Section 6a commits 50% of the net revenue from designated transactions, which transpired through NIPR. In other words, Weatherford's signature on the Aithent contract spent NIPR money—which NIPR's contract with NAIC does not authorize her to do.

Furthermore, if you are an agent or broker, Weatherford raised your costs with the stroke of her pen by agreeing to Section 6a-v, which prohibited NAIC or NIPR from reducing a price on any transaction fee by more than 15%. No matter what actual expenses demanded, NAIC/NIPR could not lower prices without violating the contract with Aithent.

Rough Notes obtained NAIC documents that denote three years when NIPR revenues triggered price decreases of 15%. *What a strange coincidence.*

Weatherford's abuse of power continues through the entire contract: 1) Weatherford granted Aithent appropriate use of the NIPR trademark; 2) Weatherford bound NIPR into a general indemnification agreement and breach of warranty policy; and 3) Weatherford grouped NAIC/NIPR customers into a single class in the event of bad debts.

Weatherford committed to all these actions when she not only lacked authority, but when she was specifically prohibited through the provisions of Section 13 of the contract between NAIC and NIPR to act as a representative of NIPR.

Perhaps consulting the wisdom of Steve Martin, the Sage Prince of 1970s Saturday Night Live, is the surest way to understanding Weatherford's actions. Through the knowledge-giving power of the Internet coupled with the Fair Use Doctrine, consider this allegorical explanation:

> You can be a millionaire…and never pay taxes! You can be a millionaire…and never pay taxes! You say…"Steve, how can I be a millionaire and never pay taxes?" First...get a million dollars. Now you say, "Steve, what do I say to the tax man when he comes to my door and says, 'You have never paid taxes'?" Two simple words. Two simple words in the English language: "I forgot!"

Other people's money

Anyone who is familiar with NAIC history will understand why the unincorporated nonprofit wanted a steady and independent source of operating revenue. Weatherford's success at expanding NAIC's income, coupled with targeted spending on commissioner travel, seemed to have shielded her actions from critical gaze.

The Classic NAIC operated on the largess of insurers for its first 40 years of existence, when it was convened to harmonize insurance regulation in the interest of stock insurance companies. State "assessments" provided a small amount of dues revenue.

Then, after the New York State's Armstrong Committee, the association gained a revenue line from conducting uniform valuations of insurers' investment securities.

After the Second World War, with the guidance of a former New York Superintendent of Insurance and Northwestern Mutual Life executive Robert Dineen, the NAIC looked for means of cutting the financial umbilical cord to the industry. Publications provided a new material revenue stream.

Dineen published a paper entitled *Insurance Regulation In The Public Interest; A Stronger NAIC.* He decried the dependence of the NAIC on both the industry and a few large states.

Bob Dineen suggested that NAIC should select one of two models for funding. He preferred a plan that gave the NAIC staff function a statutory origin. He offered *the Council of*

State Governments as a model. Dineen hinted that some portion of insurance premium tax should fund NAIC operations. For his second alternative, Dineen looked to a New York statutory provision used to fund the Securities Valuation Office at the time.

Database fees

In the late 1960s, Michigan Commissioner Russell E. Van Hooser suggested that the NAIC replicate a computer-based project to enter insurers' annual statement data—both financial and market oriented information—which his department developed with Michigan State University.

According to Commissioner Van Hooser's report, the computer could "complete an audit for an insurer in about three minutes at a cost of about $24." While those figures might sound slow and expensive today, it was certainly something out of the space age in 1969.

Inherent to each revenue stream adopted by NAIC lurked the threat of boycott. Factions within the industry threatened database fee boycott in 1980-81.

Agent licensing

In February 1990, Congressman John Dingell, then chairman of the House Energy and Commerce Committee and the Subcommittee on Oversight and Investigations, released a report entitled *Failed Promises*, which documented regulatory inadequacies that enabled a massive criminal fraud committed by Carlos Miro, a managing general agent. Dingell badgered the NAIC to develop regulatory reforms and push for their passage in the states.

One of the problems brought to light by Dingell was the inability of states to efficiently and effectively track and regulate the activities of agents and brokers across state lines. The NAIC attempted to address a lingering concern expressed by insurance producers: the automation of the agent and broker licensing process.

For more than a decade the NAIC proposed providing such services to the states but could not garner approval from its membership. Facilitating single and multistate licensing was controversial with both the states and carriers. States wanted to protect license fee revenue, so any system had to be revenue neutral to state insurance departments. Insurance carrier trade associations feared providing NAIC with a new revenue stream.

The same concern over unrestricted revenue led to the cancellation of the first incarnation of the System for Electronic Rate and Form Filing (SERFF), which would have resided under NAIC's unincorporated domain.

In 1996, the NAIC took a step designed to assuage fears of regulators and insurance carriers and still move forward with internet-based agent licensing. The NAIC chartered a new corporate affiliate in Missouri: The Insurance Regulatory Information Network (IRIN).

It soon became clear that transaction fees would provide a new and powerful source of revenue.

Although the new corporate entity was *legally* removed from the NAIC, the arrangement made no one happy. Consumer advocates and liberal commissioners criticized the inclusion of insurance sector representatives on the board of IRIN. Furthermore, if "regulatory" board members voted with the "industry" bloc, then consumer representatives saw an insurance lobby takeover of an NAIC affiliate. Industry advocates noted that "the regulators" had a majority and the executive vice president could exert strong influence over the commissioners on the board. Most important, the seed money for IRIN came from an NAIC credit line.

In the mid-1990s, there was a backlash from elements within the insurance sector to the use of NAIC as a mechanism for reform. A cabal of insurers withheld all, or part, of the database fees owed the NAIC, which resulted in a shock to the association's balance sheet. Allegations of wild spending—which actually reflected the reduction in income—cleared the way for a management change at NAIC.

Capitulation

Upon being hired by the NAIC, Cathy Weatherford worked to put an end to the association's differences with agitated trade associations. She initially achieved this end through submissive capitulation.

In the February 5, 1998, edition of *The Wall Street Journal*, Scot J. Paltrow reported on a 1996 clandestine meeting which Weatherford attended at Nick's Fishmarket restaurant outside Chicago. At that meeting, Weatherford and NAIC officers cut a deal to retard NAIC support for state regulatory efforts in return for ending the boycott of NAIC filing fees. At the June 1997 NAIC National Meeting conducted in Chicago, over the objection of the late North Carolina Insurance Commissioner Jim Long and a material opposition, the NAIC adopted a resolution endorsing Weatherford's deal.

Shortly thereafter, the NAIC conducted a series of closed door meetings to reconsider its legal composition.

The old National Association of Independent Insurers (NAII) and other voices for insurance carriers called for NAIC to be run like a business. Boy, did they get what they wanted!

Private business

By the year 2000, I had written about the NAIC for 13 years from three different perspectives: 1) working for Nationwide Insurance's government affairs office, 2) as public affairs manager for NAIC, and 3) as a newsletter writer and consumer advocate.

Regular readers of this column, who know that I am critical of NAIC-Newco, may find it surprising that the readers of my newsletter (pre-1999), considered it to be a "pro-NAIC" publication. That editorial bias shifted as Cathy Weatherford's NAIC-Newco began to operate more like a private business and less like a public entity.

Contrary to the spin which the NAIC has pushed to reporters and new insurance commissioners, my souring on the NAIC did not result from some senior managers leveling a slanderous attack on my family. In my opinion, the causal relationship was the reverse of that description.

NAIC staff members and commissioners began coming to me with examples of misuse of NAIC travel funds and accounts, and personal misuse of a corporate credit card. Sometimes documents in unmarked envelopes ended up stuck in my front door.

Like the old insurance regulatory adage that says examiners will find market conduct problems before solvency problems become clear, there was evidence that pointed to ethics trouble at NAIC-Newco.

Early warning

The failure of the NAIC to file a standard statement of the corporation's annual finances is particularly troubling. One had to ask whether the management of NAIC-Newco had reason to fear signing an IRS Form 990, which exposes the signatory to prosecution for perjury.

Rough Notes has obtained the NAIC's application for tax-exempt status. That application provides documentation of the incomplete answers provided to the IRS, which could be interpreted as misleading. For example, NAIC management provided the IRS with a 1955 IRS opinion letter, which opined that the voluntary association was an instrumentality of the states, without disclosing the existence of two opinion letters from the 1980s that contradict the 1955 opinion. The incomplete nature of the tax exempt

application will be considered in detail in a future edition of this column.

Public oversight

So does what appears to be a bad-faith and corrupted action by a former NAIC executive vice president matter nearly 13 years after the fact? The fact that the NAIC is being hauled into federal court for conflicts arising from that action certainly suggests that the concern is ripe.

Good luck Senator Nelson. I mean it. ■

The author

Kevin P. Hennosy began his insurance career in the regulatory compliance office of Nationwide Insurance Cos. and then served as public affairs manager for the National Association of Insurance Commissioners (NAIC). Since leaving the NAIC staff, he has written extensively on insurance regulation.

AGENCY FINANCIAL . . .

(continued from page 10)

Resist investment traps. Decisions to grow by investing in additional producers, new technology, consulting and other strategies must be weighed from the perspectives of time and money. Have such investments produced tangible results in the past? Do you have reliable metrics to help you make these decisions? Too often agency owners invest in promising producers, high-profile consultants or sophisticated automation systems, only to see thousands of dollars wasted when things don't turn out as expected. Sometimes the problem isn't the investment itself, but the absence of an adequate plan or poor execution of a plan. Although it's essential to invest in growth, it's critical to use reliable metrics and to be realistic about expected results so you don't get locked into large, long-term payments that hurt cash flow.

Finally, every agency must create a comprehensive and realistic annual budget to guide operations and decisions. Especially in times of economic uncertainty, many businesses function like many people—paycheck to paycheck—without a plan or regular evaluation of financial health.

Agency owners can make a big difference by comparing budget numbers to actual numbers each month to identify important trends. If, for example, income is rising faster than expected or commissions are taking longer to arrive, the budget can be adjusted for the next few months to ensure adequate cash flow. If costs are trending higher than planned, receipts can be reviewed to ascertain where money is going. With a detailed plan and regular monitoring, your agency can maintain a healthy cash flow. A plethora of resources are available to help, including software and accountants, and you don't have to spend a fortune to access them. ■

The author

Rick Dennen is president and CEO of Oak Street Funding, which provides commission-based lending for insurance agents who need capital to buy, build or sell their agency. Dennen is a licensed agent in the State of Indiana for life, accident & health products and a licensed certified public accountant in the State of Indiana. In addition, he is an instructor in venture capital and entrepreneurial finance at the Indiana University Kelly School of Business. He can be reached at rickdennen@oakstreetfunding.com.

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EXHIBIT A

EXECUTION

LICENSE AGREEMENT

This License Agreement ("Agreement") is made on this 15th day of July, 2002 (the "Effective Date") by and between the National Association of Insurance Commissioners ("NAIC"), a nonprofit Delaware corporation, with principal offices located at 2301 McGee Street, Suite 800, Kansas City, Missouri 64108 and Aithent, Inc. ("Aithent") a New York corporation, with principal offices located at 17 State Street, New York, New York 10004 (collectively referred to as the "Parties").

RECITALS

A. The NAIC is a nonprofit corporation organized under the laws of the State of Delaware whose membership consists of the chief insurance regulatory officials of the fifty states, the District of Columbia and the United States territories (collectively, the "United States");

B. Aithent is a corporation organized under the laws of the State of New York that provides software development services, maintenance services and markets software products;

C. Aithent has developed a proprietary system known as the Licensing Environment Online ("LEO") (as further defined below), an integrated system for insurance producer licensing allowing state insurance departments to electronically accept, process and manage licensing information in accordance with regulatory requirements;

D. The NAIC desires to develop State-Based Systems ("SBS"), a secured, proprietary web-based system providing software, tools, databases, and information to provide participating state insurance departments market conduct, licensing and solvency functions; and

E. The Parties desire to license to the NAIC the exclusive rights in LEO within the Insurance Sector (as that term is defined in this Agreement) in the United States, so that LEO shall be used as the basis for the development of SBS.

NOW, THEREFORE, in consideration of the mutual promises and agreements contained herein, it is hereby agreed to as follows:

EXECUTION

1. DEFINITIONS

a. **Electronic Transaction:** the electronic interaction within SBS between regulatory and non-regulatory persons and entities within the Insurance Sector with regard to a particular regulatory function including but not limited to non-resident licensing, non-resident licensing renewals, appointment renewals, resident licensing, resident licensing renewals and continuing education transactions. Exhibit A lists the initial categories (types) of Electronic Transactions. Such categories may be expanded by the addition of specific Electronic Transactions by mutual agreement of the Parties.

b. **Insurance Sector:** the market within the United States, whereby and solely to the extent any

(i) organizations and persons engaged in the business of insurance; and

(ii) organizations and persons providing support services to those engaged in (a) the business of insurance or (b) the regulation of insurance

engage in activities with, between or on behalf of state and federal governments for purposes of complying with or carrying out the laws and regulations governing the business of insurance.

c. **LEO**: the Licensing Environment Online, a proprietary web-based system developed by Aithent to electronically accept, process and manage state licensing and regulatory information in accordance with the specifications and requirements provided in Exhibit B.

d. **LION**: the Licensing Information Online Network, a proprietary client-server based system developed by Aithent that is a predecessor of LEO.

e. **License Fees**: fees which may be charged by the NAIC to SBS users for the non-exclusive right to access and use SBS and which are to be apportioned between the Parties in accordance with the terms of this Agreement.

f. **Master Services Agreement**: that certain agreement entered into by the Parties on July 15, 2002 under which Aithent has the right to provide certain software development services as more fully set forth therein.

g. **Module**: a software application or program that enables a particular Electronic Transaction.

h. **Net Revenue:** in the case of the NAIC, total amount invoiced by the NAIC and its Affiliate NIPR for License Fees and Transaction Fees, and

in the case of Aithent, license fees invoiced for licenses of LEO during the Term, in each case less return adjustments or write offs for bad debt in accordance with the applicable provisions of Exhibit C.

i. **Referral**: when the NAIC sends, directs or connects an insurance regulatory entity located outside of the United States with Aithent.

j. **SBS**: State-Based Systems, a web-based system proprietary to the NAIC providing software, tools, databases, and information to facilitate state insurance departments in their market conduct, licensing and solvency functions.

k. **State Insurance Department**: a state insurance department that has signed an SBS License Agreement and paid all applicable fees.

l. **Transaction Fee**: fees charged by the NAIC for each Electronic Transaction in or through SBS and which are to be apportioned between the Parties in accordance with the terms of this Agreement.

2. **EXCLUSIVE LICENSE TO NAIC**

a. Subject to the terms of this Agreement including, without limitation, the provisions of Section 7(d)(1) below, Aithent hereby grants, and the NAIC hereby accepts, a perpetual, non-transferable, irrevocable, exclusive right to make, use, reproduce, modify, adapt, create derivative works based on, translate, distribute, transmit, and display LEO within the Insurance Sector solely for the purpose of development, implementation, operation, modification, enhancement and maintenance of SBS (the "SBS License"). Subject to the terms of this Agreement, the SBS License shall include the right of the NAIC to use, access, modify, reverse engineer, decompile, and create derivative works based on the LEO source code solely for the purposes set forth above, provided the NAIC shall have no right of distribution or disclosure of the LEO source code, including any modifications to the source code.

b. Subject to the terms of this Agreement, including without limitation Section 7(d)(1), the NAIC shall also have a perpetual, non-transferable, irrevocable exclusive license solely within the Insurance Sector to any future enhancements, modifications, derivative works, and updates to LEO developed by Aithent.

c. Subject to the terms of this Agreement, the NAIC shall have the right to license the use, access and distribution of SBS (in object code form only) to third parties solely within the Insurance Sector.

d. Except for the license rights specifically granted herein to the NAIC for LEO within the Insurance Sector, Aithent retains all right, title and interest in LEO.

3. **EXCLUSIVE LICENSE TO AITHENT**

a. Subject to the terms of this Agreement, including without limitation Section 7(d)(2), the NAIC hereby grants, and Aithent hereby accepts, a perpetual, transferable (in accordance with Section 15), irrevocable, exclusive right to access, make, use, reproduce, modify, adapt, distribute, sub-license, create derivative works based on, and license such derivative works to third parties anywhere in the world and for any entities outside of the Insurance Sector, such portion of SBS which excludes (a) LEO and (b) any upgrade, enhancement or modification to LEO (the "Aithent License"). The Aithent License shall also include the right of Aithent to use, access, modify, reverse engineer, decompile, and create derivative works based on modifications to the SBS source code related to that portion of SBS licensed under the Aithent License. Aithent shall have no right of distribution or disclosure of the SBS source code, including any modifications to the source code.

b. For avoidance of doubt, Aithent shall have a right of first refusal to design, create and implement all modifications to SBS as may be contemplated by the NAIC or its affiliate, the National Insurance Producer Registry ("NIPR"). Notwithstanding the foregoing, the NAIC and NIPR shall always have the right to design, create and implement such modifications internally. The work on SBS to be performed by Aithent shall be pursuant to the Master Services Agreement and further specified in Scope of Works attached thereto.

c. Except for the license rights specifically granted herein to Aithent for the use of SBS outside of the Insurance Sector, the NAIC retains all right, title and interest in SBS.

4. **DELIVERY OBLIGATIONS**

a. Aithent represents and warrants that LEO, when delivered to the NAIC, will meet the specifications and requirements provided in Exhibit B, unless otherwise set forth therein.

b. Within ten (10) days after execution of this Agreement, Aithent shall deliver LEO, in object code and source code format, and its supporting documentation to the NAIC (the object code, source code, and documentation collectively the "Delivered Version").

c. During the first three (3) months following the Effective Date, Aithent shall provide at no charge at Aithent's site, reasonable technical support and training to the NAIC and its staff to enable the NAIC to load, execute and operate the Delivered Version of LEO on the NAIC's computer systems. In

the event the NAIC elects to conduct training at a NAIC site, Aithent shall provide one (1) week of on-site training at no cost to the NAIC except for the reasonable travel costs of Aithent's trainer(s). In the event the NAIC requests additional on-site support at its location, such work will be performed pursuant to the Master Services Agreement and the NAIC shall pay Aithent for such work on a time and materials basis at Aithent's then current rates, as set forth in the Master Services Agreement.

d. LEO shall be used as the foundation in the development, implementation, operation, maintenance and enhancement of SBS.

e. In the event either Party makes an enhancement or modification to LEO during the term of this Agreement, such Party shall provide to the other Party all necessary information, including applicable changes to the source code, and related documentation for the implementation of such enhancement or modification no later than thirty (30) days after such enhancement or modification is placed into production.

5. **TITLE AND OWNERSHIP**

a. Aithent owns all proprietary right, title and interest in and to LEO, owns the patent, copyright, trade secret, trade name and all other intellectual property rights in and to LEO including, but not limited to, the data bases, source codes, object codes, computer programs, compilations and presentation format; and has full power, right and authority to obtain, transmit and distribute LEO to the NAIC in the manner provided in this Agreement. Aithent retains all right, title, and ownership to any modifications to, derivative works of and improvements to LEO made by the NAIC or NAIC's affiliates and agents, whether or not authorized, provided that the development, implementation, modification, and enhancement of SBS shall not be considered a modification to, derivative work of, or improvement to LEO. It is expressly understood the NAIC obtains no rights in LEO except as expressly provided in this Agreement or in a separate agreement executed by both Parties.

b. The NAIC owns all proprietary right, title and interest in and to SBS, including the patent, copyright, trade secret, trade name and all other intellectual property rights in and to SBS including, but not limited to, the data bases, source codes, object codes, computer programs, compilations and presentation format. The NAIC retains all right, title, and ownership to any modifications to, derivative works of and improvements to SBS made by Aithent or its agents, whether or not authorized, provided that the development, implementation, modification, and enhancement of LEO shall not be considered a modification to, derivative work of, or improvement to, SBS. It is expressly understood Aithent obtains no rights in SBS except as

expressly provided in this Agreement or in a separate agreement executed by both Parties.

c. Subject to the terms of the Master Agreement with respect to Generic Materials (as that term is defined in the Master Service Agreement) each Party shall retain all rights in any software, ideas, concepts, know-how, development tools, techniques, specifications, requirements, or any other proprietary material or information that it owned or developed prior to the Effective Date, or any other proprietary material or information that it owned or developed after the Effective Date without reference to or use of the intellectual property or Confidential Information (as defined below) of the other Party. To the extent Aithent's proprietary computer software programs, ideas, concepts, know-how, development tools, or techniques, including LEO and any updates or modifications thereto regardless of the source of such updates or modifications, (collectively "Aithent Programs") are incorporated into or embedded in SBS, the NAIC, subject to the terms of this Agreement (including without limitation the provisions of Section 7(d) below), shall have a perpetual, irrevocable, non-transferable, exclusive license to the Aithent Programs within the Insurance Sector solely for purposes of development, implementation, operation, modification, enhancement and maintenance of SBS.

6. **COMPENSATION**

a. **Royalty to Aithent**

i. In consideration of the rights granted by Aithent to the NAIC herein, the NAIC shall pay a royalty ("SBS Royalty Payment") which shall be calculated as fifty percent (50%) of the Net Revenue received by the NAIC or NIPR, for the Electronic Transactions listed in Exhibit A, except that the SBS Royalty Payment shall not include Net Revenue for appointment/termination transactions with those State Insurance Departments identified in Exhibit D that are processing electronic appointment/termination transactions through NIPR prior to the Effective Date. The NAIC shall not be obligated to pay, and Aithent shall not be entitled to collect, royalties on other fees (e.g., credit card processing fees) or monies collected by or on behalf of State Insurance Departments. Upon Aithent's request, the NAIC shall identify to Aithent the types of such other fees and monies.

ii. Aithent shall at all times be solely entitled to collect all royalties and fees due to Aithent from Aithent's license of LION to the State Insurance Departments set forth in Exhibit E for so long as such State Insurance Departments continue to license any portion of LION. To the extent that a State Insurance Department identified

in Exhibit E (a) desires to license LEO but not SBS or (b) requests Aithent to provide services not provided by the NAIC (including Electronic Transactions not provided via SBS), Aithent shall at all times be solely entitled to all such royalties and fees resulting therefrom, provided the NAIC is not required to support or maintain LEO for such State Insurance Departments. Notwithstanding the foregoing, if a State Insurance Department identified in Exhibit E elects to license both LEO and SBS and the NAIC processes LEO-based electronic transactions at no cost to Aithent, the SBS Royalty Payment shall apply to the sum of (y) the Transaction Fees generated by the Electronic Transactions and (z) any transaction fees generated by the LEO-based electronic transactions processed through SBS for such state, provided the NAIC is not required to support or maintain LEO for such State Insurance Department.

iii. Each time a State Insurance Department implements an Electronic Transaction using SBS, the SBS Royalty Payment for that State Insurance Department's Electronic Transaction shall be due for a period of five (5) years from the date of first implementation of such Electronic Transaction (the "SBS Royalty Period"). After the expiration of a SBS Royalty Period, the NAIC shall no longer owe, and Aithent expressly waives the right to, the SBS Royalty Payment for such State Insurance Department's Electronic Transaction. Notwithstanding the foregoing, the SBS Royalty Payment for Electronic Transactions for State Insurance Departments listed in Exhibit E shall be due and owing from the date of first implementation of such State Insurance Department's Electronic Transaction up and until the tenth (10^{th}) anniversary of the Effective Date, even if such period is longer than the SBS Royalty Period for such Electronic Transaction.

iv. The SBS Royalty Payment shall be due on a monthly basis. On or before the fifteenth (15th) day of every calendar month, the NAIC shall pay to Aithent by check a SBS Royalty Payment based on the License Fees and Transaction Fees received for the preceding calendar month. Each SBS Royalty Payment shall be delivered by overnight courier and shall be accompanied by a detailed statement in a format as provided for in Exhibit F (or as otherwise agreed to by the Parties) itemizing the number of Electronic Transactions by State Insurance Department corresponding to the License Fees and Transaction Fees.

v. The NAIC and NIPR, shall have sole discretion to establish, increase or decrease License and Transaction Fees for SBS within the Insurance Sector. Notwithstanding the foregoing, the NAIC

represents it will support, and recommend to the NIPR board of directors, that a Transaction Fee remain in effect and be assessed by NIPR for the transactions listed in Exhibit A; and, moreover, the NAIC will not take any actions to drastically reduce or eliminate such Transaction Fees unless the NAIC's Executive Committee determines there is a need to do so in order to satisfy important regulatory policy. Notwithstanding the foregoing, the price of a Transaction Fee for the transactions listed in Exhibit A shall not be reduced by more than fifteen percent (15%) during any calendar year unless otherwise mutually agreed to by the Parties.

vi. The NAIC shall make reasonable efforts to market SBS.

b. **Royalty to the NAIC From Referrals**

i. Aithent shall pay a royalty ("Referral Royalty Payment") to the NAIC for any Referrals made by the NAIC which result in a license of LEO during the ten (10) years following the Effective Date. The Referral Royalty Payment shall equal twenty-five (25%) of Net Revenue received by Aithent as a result of the license of LEO. The royalty shall be due for a period of five (5) years (the "Referral Royalty Period") after the date Aithent first receives Net Revenue from each such license.

ii. Referral Royalty Payment shall be due on a quarterly basis. On or before the fifteenth (15th) day of the first month of each calendar quarter, Aithent shall submit the Referral Royalty Payment based on the Net Revenues received for the preceding calendar quarter. With each Referral Royalty Payment, Aithent shall also send a detailed statement, in a format provided for in Exhibit F (or as otherwise agreed to by the Parties) supporting the Referral Royalty Payment. After the expiration of the Referral Royalty Period for each such Referral, Aithent shall no longer owe, and the NAIC expressly waives the right to, the Referral Royalty Payment for each such Referral.

c. **Recordkeeping and Audit**

Each Party shall maintain business and financial records containing information sufficient to verify the completeness and accuracy of each Royalty Payment made to the other Party for a period of at least three (3) years after the period to which such Royalty Payment relates. No more than once each calendar year, and at other times as provided for in Section 7(d), each Party shall have the right, upon reasonable advance notice to the other Party, to have a nationally recognized accounting firm designated by the Party subject to examination examine such records during regular business hours

and in a manner designed not to disrupt the examined Party's normal business operation, for the sole purpose of verifying the completeness and accuracy of the Royalty Payments; provided that as a condition to making such investigation the accountant making such investigation shall execute an agreement, in reasonable form, to maintain the confidentiality of such records and not to disclose any information with respect thereto to any person, including the Party who is the subject of the examination, other than to confirm to the Parties the completeness and accuracy of the Royalty Payments or to advise the Parties of any discrepancies thereof. In the event such examination shall disclose that a Party understated Royalty Payments for any period, such Party shall pay within fifteen (15) days after the completion and disclosure of the examination to the other Party an amount equal to the amount of all unpaid Royalty Payments, plus interest for the period from the date of the Royalty Payment statement through the date payment is received equal to the prime rate listed in the Wall Street Journal as of the date of the statement for the understated Royalty Payment. If any Royalty Payment for an annual period is understated in excess of five percent (5%), the Party understating the Royalty Payment shall pay the reasonable costs of conducting the audit, otherwise the Party requesting the audit shall bear such costs. If such audit shall identify that an overpayment has been made, such overpayment shall be deducted in full from the paying Party's next payment to the other Party, <u>provided</u> that, after such deduction, any remaining overpayment shall be carried over to future payments by the paying Party until such overpayment has been extinguished; <u>provided, however</u>, that if no further payments are scheduled to be made by the paying Party, any remaining overpayment shall be promptly paid by the receiving Party to the other Party.

7. TERM AND TERMINATION

a. Each Party's obligation to make royalty payments to the other Party under this Agreement shall end on the tenth (10^{th}) anniversary of the Effective Date. At that time the license granted hereunder to the NAIC shall be deemed fully paid. In the alternative, at any time after the fifth (5^{th}) anniversary of the Effective Date, the NAIC may elect to pay up the license at any time by paying an amount to Aithent equal to the net present value (calculated using the prime rate listed in the *Wall Street Journal* as of the date the NAIC tenders payment to Aithent (the "Tender Date")) applied to the aggregate annual SBS Royalty Payment projected for each of the next three (3) years. Such aggregate annual SBS Royalty Payment shall be calculated by taking the annual growth rate of the SBS Royalty Payment (calculated over the two (2) years preceding the Tender Date) applied to the aggregate annual SBS Royalty Payment for the twelve (12) months preceding the Tender Date.

b. The Parties may terminate this Agreement by mutual consent upon such terms as they may agree upon in writing.

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c. In the event of a material breach of this Agreement other than a breach due to the failure of a Party to pay any amounts due to the other Party, the non-breaching Party shall provide written notice to the breaching Party specifying the material breach. The breaching Party shall have sixty (60) days from the receipt of written notice within which to cure the material breach. If the breaching Party fails to cure the material breach, the non-breaching Party shall be entitled to exercise its rights under the law, subject to the terms of Sections 7(d) and 13 below.

d. In the event of a material breach of this Agreement due to a Party's failure to pay any amounts due to the other Party pursuant to Section 6 of this Agreement, the following conditions shall apply:

(1) If the breaching Party is the NAIC,

(a) on the first such breach of the Agreement, the NAIC shall have thirty (30) days from the receipt of written notice of such breach within which to cure the breach. No additional penalty other than those set forth herein for late payments shall attach if such breach is cured within the prescribed period.

(b) if such breach is not cured within the prescribed period, or in the event a second breach of the Agreement occurs within two (2) years of the first breach that remained uncured at the expiration of the prescribed cure period and such second breach is not cured within twenty (20) days from the receipt of written notice of such breach, Aithent may immediately terminate the NAIC's exclusivity rights under the Agreement. The NAIC may continue to use the LEO software licensed under the SBS License, however, the exclusivity provisions of the SBS License shall immediately and automatically terminate as of Aithent's written notice of breach to the NAIC and the NAIC shall remain obligated to pay all SBS Royalty Payments for all States to which SBS is licensed or may be licensed thereafter.

(c) in the event a third such breach of the Agreement occurs within two (2) years of the second breach that remained uncured at the expiration of the prescribed cure period and such third breach is not cured within ten (10) days from the receipt of written notice of such breach, the NAIC shall promptly pay to Aithent liquidated damages in the amount of fifty percent (50%) of the SBS Royalty Payment which was paid (or should have been paid) by the NAIC to Aithent in the prior quarter. For avoidance of doubt, the NAIC may continue to use the LEO software licensed under the SBS License only in those States with SBS licenses in effect as of the date of Aithent's written notice of breach to the NAIC; however, LEO may not thereafter be sub-licensed to any other States.

(d) in the event a fourth such breach of the Agreement occurs within two (2) years of the third breach that remained uncured at the expiration of the prescribed cure period and such fourth breach is not cured within ten (10) days from the receipt of written notice of such breach, the NAIC shall promptly pay to Aithent liquidated damages in the amount of fifty percent (50%) of the SBS Royalty Payment which was paid (or should have been paid) by the NAIC to Aithent for the prior quarter. In addition, the perpetual and irrevocable nature of the SBS License shall immediately and automatically terminate as of the date of Aithent's written notice of breach to the NAIC. The NAIC may continue to use the LEO software licensed under the SBS License, however, such SBS License shall terminate with respect to each State with SBS licenses then in effect at the completion of each such State's then-current SBS license term.

(e) The SBS License restrictions set forth above shall apply regardless of the NAIC's cure of, or failure to cure, any breach of the type contemplated by this Section 7(d).

(f) In the event that the NAIC's failure to pay is the result of a good faith dispute ("Good Faith Dispute") and the NAIC has timely paid all undisputed SBS Royalty Payments then due and owing to Aithent, the SBS License restrictions set forth above shall not apply, and the Parties shall attempt to resolve such Good Faith Dispute informally, provided that within ten (10) days of the resolution of such Good Faith Dispute the NAIC pays to Aithent such SBS Royalty Payments as may then be due and owing to Aithent as the result of such resolution, in which case no breach shall be deemed to have occurred for the purposes of this Section 7(d). The NAIC's failure to so pay shall be deemed a breach under the terms of this Section 7(d).

Notwithstanding the foregoing Section 7(d)(1)(f), if the Good Faith Dispute is not informally resolved, Aithent, prior to exercising its rights to payment and to restrict the SBS License as stated above, shall conduct an examination of the NAIC's relevant business and financial records in accordance with Section 6(c) to substantiate the payment dispute. If the examination shows that the NAIC owes payment to Aithent, the NAIC shall have ten (10) days after the completion and disclosure of the results of the examination within which to make such payment. The payment of costs for the examination shall be paid in accordance with the terms of Section 6(c). If the NAIC fails to make payment of all monies due and owing as a result of the examination within said ten (10) days, such failure to pay shall be deemed a material breach under this Section 7(d).

(2) If the breaching Party is Aithent,

(a) on the first such breach of the Agreement, Aithent shall have thirty (30) days to cure from receipt of a written notice within which to cure the breach. No additional penalty other than those set forth herein for late payments shall attach if such breach is cured within the prescribed period.

(b) if such breach is not cured within the prescribed period, or in the event a second breach of the Agreement occurs within two (2) years of the first breach that remained uncured at the expiration of the prescribed cure period and such second breach is not cured within twenty (20) days from the receipt of written notice, the NAIC may immediately terminate Aithent's exclusivity rights under the Agreement. Aithent may continue to use the NAIC materials licensed under the Aithent License, however, the exclusivity provisions of the Aithent License shall immediately and automatically terminate as of the NAIC's written notice of breach to Aithent and Aithent shall remain obligated to pay all Referral Royalty Payments as they come due under this Agreement.

(c) in the event a third breach of the Agreement occurs with two (2) years of the second breach that remained uncured at the expiration of the prescribed cure period and such third breach is not cured within ten (10) days following receipt of written notice, Aithent may continue to use the NAIC materials licensed under the Aithent License for only for those Aithent customers with agreements with Aithent in effect as of the date of the NAIC's written notice of breach to Aithent; however, the materials comprising the Aithent License may not thereafter be provided to any other Aithent customers.

(d) in the event a fourth breach of the Agreement occurs within two (2) years of the third breach that remained uncured at the expiration of the prescribed cure period and such fourth breach is not cured within ten (10) days following receipt of written notice, Aithent shall also promptly pay to the NAIC liquidated damages in the amount of fifty percent (50%) of the Referral Royalty Payment which was paid (or should have been paid) by Aithent to the NAIC in the prior quarter. In addition, the perpetual and irrevocable nature of the Aithent License shall immediately and automatically terminate as of the date of the NAIC's written notice of breach to Aithent. Aithent may continue to use the materials licensed under the Aithent License, however, such Aithent License shall terminate with respect to each Aithent customer with agreements utilizing such materials then in effect at the completion of each such customer's then-current agreement.

(e) The Aithent License restrictions set forth above shall apply regardless of Aithent's cure of, or failure to cure, any breach of the type contemplated by this Section 7(d).

(f) In the event that Aithent's failure to pay is the result of a Good Faith Dispute and Aithent has timely paid all undisputed Referral Royalty Payments then due and owing to the NAIC, the Parties shall attempt to resolve the Good Faith Dispute informally, provided that within ten (10) days of the resolution of such Good Faith Dispute Aithent pays to the NAIC such Referral Royalty Payments as may then be due and owing to the NAIC as the result of such resolution, in which case no breach shall be deemed to have occurred for the purposes of this Section 7(d). Aithent's failure to so pay shall be deemed a breach under the terms of Section 7(d).

Notwithstanding the foregoing Section 7(d)(2)(f), if the Good Faith Dispute is not informally resolved, the NAIC, prior to exercising its rights to payment and to terminate the Agreement, shall conduct an examination of Aithent's relevant business and financial records in accordance with Section 6(c) to substantiate the payment dispute. If the examination shows that Aithent owes payment to the NAIC, Aithent shall have ten (10) days after the completion and disclosure of the results of the examination within which to make such payment. The payment of costs for the examination shall be paid in accordance with the terms of Section 6(c). If Aithent fails to make payment of all monies due and owing as a result of the examination within said ten (10) days, such failure to pay shall be deemed a material breach under this Section 7(d).

e. Upon termination of this Agreement for a material, uncured breach, the licenses granted hereunder to the breaching Party shall immediately terminate; however, the licenses granted to the non-breaching Party shall continue provided the non-breaching party continues to fulfill its obligations under the license granted to it as set forth herein. Termination or expiration of this Agreement for any reason other than a material, uncured breach shall have no effect on the licenses granted to each Party herein or the Parties' respective payment obligations to each other, provided that the Parties continue to meet their respective ongoing obligations under the licenses granted to them as set forth herein. Notwithstanding the foregoing, upon termination or expiration of this Agreement for any reason, the Parties shall cease to have any obligations to each other with respect to the provision of source code for upgrades and modifications to LEO and SBS.

8. **TRADEMARKS; COPYRIGHTS**

a. During the term of this Agreement, the NAIC shall at all times display the "Powered by Aithent" symbol, Aithent trademark, logo and trade name

("Aithent Marks") on SBS and at a minimum, shall include the Aithent Marks on the SBS splash screen and log-in screens. The NAIC shall be licensed to use the Aithent Marks and the LEO trademark and logo in strict accordance with Aithent Trademark Usage Guidelines to be provided to the NAIC by Aithent not later than thirty (30) days following the Effective Date, as such Aithent Trademark Usage Guidelines may be changed from time to time at the sole discretion of Aithent.

b. During the term of this Agreement, Aithent shall be licensed to use the NAIC (and as appropriate, the NIPR) trademark, logo and trade name and the SBS trademark and logo and such other commercial indicia as the NAIC may require (collectively, the "NAIC Marks") in all instances where Aithent shall use SBS. All such use of the NAIC Marks shall be in strict accordance with the NAIC Trademark Usage Guidelines to be provided to Aithent by the NAIC not later than thirty (30) days following the Effective Date, as such NAIC Trademark Usage Guidelines may be changed from time to time at the sole discretion of NAIC.

c. Neither Party shall, at any time, use, register or cause any third party to use or register any name, trademark, service mark, logo or symbol which may be confusingly similar to the other Party's trademarks, trade names, logos, symbols or product names. The licenses issued hereunder shall in no way convey to the licensee Party any right, title or ownership in the Marks of the Licensor Party.

d. In displaying the NAIC's copyright notices and designation of SBS, the NAIC shall at all times include appropriate and complete copyright information with respect to LEO components and modifications included in SBS by indicating that a portion of SBS includes copyrighted material of Aithent on, at a minimum, the "About" display or its equivalent. Aithent shall provide the NAIC from time to time with such updated copyright information as appropriate; the NAIC shall promptly cause the content of such updated copyright information to be included in the copyright notice of SBS as set forth above.

9. **WARRANTY OF TITLE AND NON-INFRINGEMENT AND INDEMNIFICATION**

a. Each Party represents and warrants that (i) the software and documentation it provides to the other Party hereunder will not, as of the date of delivery of such software and documentation, violate the intellectual property rights of any third party under U.S. patent, copyright, trademark or trade secret laws; and (ii) it has full power and right to enter into this Agreement, to license said software and documentation and to grant the exclusive rights to the other Party as set forth herein.

b. Each Party will indemnify and hold harmless the other Party (and, in the case of the NAIC, NIPR), their employees and agents from all loss, cost, liability, and expense, including actual attorneys' fees, arising out of any claim that any software or documentation provided by such Party and, as used within the scope of this Agreement, infringes any patent, copyright, trade secret, or other proprietary right of a third party.

c. The NAIC (and its affiliate, NIPR) shall defend, indemnify and hold harmless Aithent from and against any and all claims, suits, actions, losses, damages, liabilities, costs and expenses (including reasonable attorneys' fees and court costs) brought or claimed by third parties against or from Aithent resulting from or relating to any breach by the NAIC (or its affiliate, NIPR) of its obligations, duties, responsibilities, representations or warranties under any agreement between the NAIC (or its affiliate, NIPR) and its customers with respect to the licensing, or provision of SBS or any SBS-related services.

d. Upon receipt of a claim arising under this Section, the indemnified Party shall (i) promptly provide the indemnifying Party prompt written notice of the claim; (ii) provide all reasonable assistance at the indemnifying Party's expense to defend against the claim; (iii) allow the indemnifying Party to control the defense and settlement of the claim provided that the indemnifying Party does not enter into any settlement or compromise that imposes any obligation or liability upon the indemnified Party (and in the case of the NAIC, NIPR), without the prior written consent of the indemnified Party. The indemnified Party shall have the right to retain its own legal counsel and participate in the defense of the claim at its sole expense.

e. In the event the use of any software or documentation provided by a Party is permanently enjoined for any reason, such Party shall, at its sole cost, either (i) modify the software or documentation to avoid infringement; or (ii) procure the right for the other Party to continue to use such software or documentation. If neither remedy is reasonably available, the non-infringing Party may terminate this Agreement as if for a material, uncured breach.

f. Aithent shall have no obligation under this Section for or with respect to claims, actions, or demands alleging infringement of its software or documentation to the extent such claims, actions, or demands arise as a result of (i) the combination of noninfringing items supplied by Aithent with any items not supplied by it; or (ii) modifications to LEO made by, at the direction of, or on behalf of the NAIC.

10. **DISCLAIMER OF WARRANTIES AND LIMITATION OF LIABILITES AND REMEDIES; FORCE MAJEURE**

a. **Disclaimer of Warranties.**

Aithent represents and warrants that the Delivered Version and any version of LEO delivered pursuant to Section 4 (collectively, "Versions of LEO") shall perform in accordance with its specifications. Aithent does not, however, warrant that the NAIC's or NIPR's use of the Versions of LEO will be error-free or uninterrupted. Aithent will, at its own cost and expense and as its sole obligation (and NAIC and NIPR's exclusive remedy for any breach of this warranty), use its commercially reasonable efforts to promptly correct any reproducible error in the Versions of LEO that NAIC reports to Aithent in writing.

OTHER THAN AS EXPRESSLY PROVIDED IN THE AGREEMENT, AITHENT MAKES NO WARRANTY OR PROMISE, EITHER EXPRESS OR IMPLIED, ORAL OR WRITTEN, WITH RESPECT TO THE VERSIONS OF LEO INCLUDING WITHOUT LIMITATION THE IMPLIED WARRANTY OF MERCHANTABILITY AND FITNESS FOR ANY PARTICULAR PURPOSE.

To the extent that a warranty may not be disclaimed under applicable law, the scope and duration of such warranty shall be the minimum permitted under such law. The NAIC acknowledges that it has relied on no warranties of Aithent other than the express warranties set forth herein, in entering into this Agreement.

b. **LIMITATION OF LIABILITY.**

AITHENT SHALL NOT BE LIABLE FOR AND THE NAIC EXPRESSLY WAIVES ANY CLAIM FOR ANY INCIDENTAL, CONSEQUENTIAL, OR SPECIAL DAMAGES (INCLUDING, BUT NOT LIMITED TO, LOST SALES, LOST PROFIT, BUSINESS INTERRUPTION, LOSS OF DATA OR LOSS OF OR INABILITY TO USE ANY COMPUTER, SYSTEM, SOFTWARE OR COMPONENT), SUFFERED BY THE NAIC OR ANY THIRD PARTY AS A RESULT OF SUCH PARTY'S RELIANCE ON THE VERSIONS OF LEO, SBS, ANY MODIFICATIONS THERETO, OR ANY SERVICES PERFORMED BY AITHENT UNDER THE MASTER SERVICES AGREEMENT, WHETHER THE SAME ARE INCURRED OR SUFFERED BY THE NAIC OR ANY THIRD PARTY, AND WHETHER BASED IN CONTRACT, TORT OR OTHERWISE.

THE NAIC SHALL NOT BE LIABLE FOR AND AITHENT EXPRESSLY WAIVES ANY CLAIM FOR ANY INCIDENTAL, CONSEQUENTIAL, OR SPECIAL DAMAGES (INCLUDING, BUT NOT LIMITED TO, LOST SALES, BUSINESS INTERRUPTION, LOSS OF DATA OR LOSS OF OR INABILITY TO USE ANY COMPUTER, SYSTEM, SOFTWARE OR

COMPONENT), SUFFERED BY AITHENT OR ANY THIRD PARTY AS A RESULT OF SUCH PARTY'S RELIANCE ON THE VERSIONS OF LEO, SBS, ANY MODIFICATIONS THERETO, OR ANY SERVICES PERFORMED BY THE NAIC, WHETHER THE SAME ARE INCURRED OR SUFFERED BY AITHENT OR ANY THIRD PARTY, AND WHETHER BASED IN CONTRACT, TORT OR OTHERWISE.

IN ADDITION, EXCEPT FOR EACH PARTY'S INDEMNIFICATION OBLIGATIONS HEREUNDER, THE AGGREGATE AMOUNT OF EACH PARTY'S LIABILITY TO THE OTHER PARTY OR ANY THIRD PARTY UNDER ANY CLAIM FOR LOSS OR LIABILITY BASED UPON, ARISING OUT OF, RESULTING FROM, OR IN ANY WAY CONNECTED WITH THE PERFORMANCE OR BREACH OF THIS AGREEMENT SHALL IN NO CASE EXCEED (A) WITH RESPECT TO AITHENT, THE SUMS RECEIVED HEREUNDER BY AITHENT FROM THE NAIC FOR THE SIX (6) MONTHS PRECEDING THE EVENT GIVING RISE TO SUCH CLAIM APPLICABLE TO THE STATE FOR WHICH SUCH CLAIM ARISES AND (B) WITH RESPECT TO THE NAIC, THE SUMS RECEIVED BY AITHENT AND DUE AND OWING HEREUNDER BY THE NAIC FOR THE SIX (6) MONTHS PRECEDING THE EVENT GIVING RISE TO SUCH CLAIM APPLICABLE TO THE STATE FOR WHICH SUCH CLAIM ARISES.

11. NON-COMPETITION

Aithent shall not market, sell, distribute or otherwise deliver LION to any person or organization within the Insurance Sector. Aithent may continue to support, service and customize LION for the existing customers identified in Exhibit E. In addition, Aithent may provide support, maintenance and customization services for any such customers identified in Exhibit E who elect to license LEO and not SBS.

12. CONFIDENTIALITY

Each Party acknowledges that it will have access to proprietary or otherwise confidential information of the other ("Confidential Information"). Aithent's Confidential Information shall include (without limitation) (a) the LEO software (including modifications thereto) including but not limited to the source code, (b) the tools, methodology, know-how, ideas, techniques, procedures, documents and designs that Aithent uses or employs in the delivery of LEO (including modifications thereto) and implementation, maintenance and enhancements to LEO and SBS and (c) the terms and conditions of this Agreement; and (d) all other Aithent information which would reasonably be considered confidential. The NAIC's Confidential Information shall include (without limitation) (v) the SBS software including but not limited to its source code; (w) SBS's specifications, performance requirements, processes, data; (x) the NAIC's tools, methodology, know-how, ideas, techniques, procedures, documents and designs that NAIC provides to Aithent to facilitate the delivery of LEO and SBS and the

implementation, maintenance and enhancements to LEO and SBS; (y) client or member information and (z) all other NAIC information which would reasonably be considered confidential.

A disclosing Party's Confidential Information shall not include, however, information that:

i. is or becomes a part of the public domain through no act or omission of the other Party;

ii. was in the other Party's lawful possession prior to the disclosure thereof by the disclosing Party and had not been obtained by the other Party either directly or indirectly from the disclosing Party;

iii. is lawfully disclosed to the other Party by a third party that is not subject to any restriction on disclosure;

iv. is independently developed by the other Party without reference to the disclosing Party's Confidential Information;

v. is required to be disclosed by the other Party pursuant to any law, rule or regulation, governmental authority, duly authorized subpoena, court order or administrative process;

provided, however, that the other Party must provide written notice to the disclosing Party prior to such disclosure and cooperate with the disclosing Party to facilitate its obtaining confidential treatment of such information required to be disclosed; or is approved (by prior written consent) for disclosure by the disclosing Party.

Each Party agrees, during the term of this Agreement and for a period of two (2) years thereafter, (A) to hold the Confidential Information of the other Party in strict confidence and to use such Confidential Information only in connection with the performance of its obligations under this Agreement, (B) not to make any copies of such Confidential Information or any portions thereof without the express written permission of the other Party, (C) not to disclose such Confidential Information or any part thereof to any person outside the Party's business organization for any purpose, (D) to limit dissemination of such Confidential Information within that Party's business organization to persons who have a need to see the Confidential Information in connection with the performance of its obligations under this Agreement and (E) if requested, to return such Confidential Information and any copies thereof to the other Party upon the completion of the Services to which such Confidential Information relates, or at such later date as the other Party may require. Notwithstanding the foregoing, each Party shall be entitled to retain a set of its working papers, even if such working papers contain Confidential Information of the other Party. For purposes of this paragraph, "business organization" means a Party's parent entities, subsidiaries and other affiliated entities.

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Notwithstanding the foregoing and subject to the terms of this Agreement, the NAIC hereby grants Aithent a perpetual, worldwide, irrevocable, non-exclusive license to use NAIC's Confidential Information, provided the Confidential Information is solely limited to information regarding the automated processes developed or used by the NAIC to support the regulatory framework of the Insurance Sector, for the sole purpose of incorporating into LEO and such of Aithent's other proprietary software as Aithent deems appropriate and necessary to develop, use, and license solely to insurance regulatory entities located outside the United States. Except as provided in Section 3, this limited license does not permit Aithent to use NAIC's Confidential Information to provide software or services to third parties other than insurance regulatory entities located outside of the United States. Except as set forth herein and as may be provided in a separate agreement signed by each of Aithent and the NAIC specifically referencing such Confidential Information incorporated into LEO, NAIC agrees that it shall have no right, title or interest in or to any modifications to LEO based on such Confidential Information.

13. DISPUTE RESOLUTION

Any dispute, controversy or claim arising under, out of, in connection with or in relation to this Agreement, or the breach, termination, validity or enforceability of any provision hereof (a "Dispute"), if not resolved informally through negotiation between the Parties, will be submitted to non-binding mediation. The Parties will mutually determine who the mediator will be from a list of mediators knowledgeable in the subject matter hereof and obtained from the American Arbitration Association (the "AAA") office located in the city determined as set forth below in this Section. If the Parties are unable to agree on the mediator, the mediator will be selected by the AAA. If any Dispute is not resolved through mediation, the Parties shall have a period of one year from the date of the last mediation to bring a lawsuit or action in federal district court in the city determined as set forth below.

Any negotiation, mediation or lawsuit pursuant to this Section will take place or be filed in New York, New York, if initiated by the NAIC, and in Kansas City, Missouri, if initiated by Aithent. With regards to any negotiation or mediation, each Party will bear its own costs and expenses with respect to any negotiation or mediation, including one-half of the fees and expenses of the mediator, if applicable. In the event a lawsuit results in a judgment (other than settlement), the prevailing Party shall be entitled to an award of reasonable attorneys' fees and expenses.

The Parties agree that the provisions of this Section are a complete defense to any suit, action or other proceeding instituted in any court or before any administrative tribunal with respect to any Dispute. Nothing in this Section prevents the Parties from exercising their right to terminate this Agreement in accordance with Section 7.

14. **GOVERNING LAW**

By adoption of the Parties, the State of New York is deemed to be the place of contracting and by agreement of the Parties, any claim or controversy relating to this Agreement, its interpretation, performance or validity shall be construed and governed in accordance with the laws of the State of New York, without regard to its choice of laws rules.

15. **NO ASSIGNMENT**

Neither this Agreement nor any of the rights granted hereunder shall be transferable or assignable by either Party without the prior written consent of the other Party. However, this Agreement shall be assignable by Aithent to the purchaser or transferee ("Successor") of that portion of Aithent's business to which this Agreement relates to the extent that Aithent deems necessary to effectuate the disposition of such portion of its business. Provided the Successor agrees in writing to be bound to the rights and obligations of this Agreement and provides reasonable evidence to the NAIC that it has the financial and technical resources to fulfill the obligations of this Agreement, this Agreement shall be binding upon and inure to the benefit of the assignee and Aithent shall have no further obligations or liability hereunder.

16. **NOTICES**

All notices required or permitted to be given hereunder shall be in writing. Except as otherwise expressly stated in this Agreement, such notices shall be deemed to have been properly given (a) on the date delivered, if personally delivered, (b) one (1) business day after the date sent by facsimile, with automatic confirmation by the transmitting machine showing that the proper number of pages were transmitted without error (with a hard copy of such pages mailed promptly by United States postage-prepaid first class mail to the recipient of such telecopy transmission), (c) five (5) business days after mailing, if mailed by registered or certified mail, postage prepaid, with return receipt requested and proof of sending provided (but only if the receiving party is located within the United States) and (d) two (2) business days after mailing, if sent by recognized overnight express courier service, charges prepaid, with "next day" or "next business day" service specified and proof of sending provided (if the receiving party is within or outside the United States), in each case to the receiving party at its address or facsimile number set forth below (or to such other address or facsimile number as the receiving party may designate in accordance with this section):

N. Venu Gopal, Chief Executive Officer
Aithent, Inc.
17 State Street
New York, New York 10004
Fax No.: 212.271.6368

with a copy to:

EXECUTION

William E. Bandon, III, Esq.
Brown Raysman Millstein Felder & Steiner LLP
900 Third Avenue
New York, NY 10022-4728
Fax: 212.895.2900

Chief Information Officer
National Association of Insurance Commissioners
2301 McGee Street
Suite 800
Kansas City, Missouri 64108-2604
Fax: 816.783.8053

with a copy to:

General Counsel
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, Missouri 64108
Fax: 816.783.8054

17. **INDEPENDENT RELATIONSHIP OF THE PARTIES**

Nothing in this Agreement shall be construed to constitute or appoint either Party as a partner, joint venturer, agent or representative of the other Party for any purpose whatsoever, or to grant to either Party any rights or authority to assume or create any obligation or responsibility, express or implied, for or on behalf of or in the name of the other, or to bind the other in any way or manner whatsoever.

18. **WAIVER**

No provision of this Agreement shall be waived and no breach excused unless the waiver or consent is in writing and is signed by the Party that is claimed to have waived or consented. No course of dealing or omission or delay on the part of either Party hereto in asserting or exercising any right hereunder shall constitute or operate as a waiver of any such right.

19. **SEVERABILITY; CONFLICT**

If any provision herein is held to be invalid or unenforceable for any reason, the remaining provisions will continue in full force without being invalidated in any way. In

the event of any direct conflict between the terms of this Agreement and the terms of the Master Services Agreement, the terms of this License shall govern.

20. FORCE MAJEURE

Excluding their respective payment obligations hereunder, neither Aithent nor the NAIC shall be held responsible for, nor deemed to be in default under this Agreement because of, any delay or failure in its performance if such delay or failure is the result of causes beyond its reasonable control (provided such causes do not result from the acts or omissions of such Party or its officers, managers, employees or personnel). Such causes shall include (without limitation) acts of God, fire, flood, earthquake, severe weather, transportation disruption, communications failure, failure of electronic or mechanical equipment, telephone or other interconnect problem, Internet problem, unauthorized access, theft, operator error, strike or other labor dispute, war, civil disruption, insurrection or any other cause beyond the reasonable control of such party (all such causes collectively referred to herein as "Force Majeure"). The Party affected by a Force Majeure shall, upon giving prompt written notice to the other Party thereof, be entitled to suspend its performance hereunder on a day-to-day basis to the extent of the prevention, restriction or interference caused by such Force Majeure; provided, however, that the Party affected shall at all times use its commercially reasonable efforts to avoid or remove such prevention, restriction or interference and to minimize the consequences thereof. The Party affected shall resume its performance immediately upon elimination or removal of such Force Majeure or its effects. To the extent the Party affected by such Force Majeure is entitled to suspend its performance, the Party not affected by such Force Majeure shall also be entitled to suspend its performance. In the event a Force Majeure continues for more than sixty (60) days, the Party not seeking relief under this provision may terminate the Agreement immediately, and the provisions of Section 7 shall apply.

21. HEADINGS

Headings are for reference purposes only and in no way define, limit, construe or describe the extent of such section.

22. SURVIVAL OF PROVISIONS

The following provisions shall survive termination of this Agreement: 1, 2, 3 (with respect to the irrevocable, perpetual and exclusive nature of Aithent License and the SBS License), 5, 6, 7 (with respect to royalty payments, audits, termination and license restrictions for non-payment), 8 (with respect to copyright notices), 9, 10, 11, 12, 13, 14, 15, 16, 18, 19, 20, 21, 22, and 24.

23. COUNTERPARTS

This Agreement may be executed in counterparts, each of which shall be deemed to be an original and all of which shall constitute one and the same Agreement.

24. **ENTIRE AGREEMENT**

This Agreement constitutes the entire agreement of the Parties on this subject matter, and supersedes all prior agreements, understandings and proposals, oral or written, between the Parties. No amendments or modifications to this Agreement shall be valid unless in writing and signed by both Parties.

[The remainder of this page is intentionally left blank.]

EXECUTION

IN WITNESS WHEREOF, the Parties hereto have executed this Agreement on the day and year first above written.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS	AITHENT, INC.
Catherine J. Weatherford Signature	N.V. [redacted] Signature
Catherine J. Weatherford Printed Name	N. Venu Gopal Printed Name
Executive Vice President Title	CEO Title
7/17/02 Date	July/17/2002 Date

EXECUTION

EXHIBIT A

The following Electronic Transactions, as this term is defined in the Agreement, will be included in SBS v. 1.0 and subject to Royalty Payment as set forth in Section 6(a) of the Agreement.

Type of Electronic Transaction

Non-Resident Licensing
Non-Resident Licensing Renewals
Appointment Renewals
Resident Licensing
Resident Licensing Renewals
Continuing Education Transactions

This Exhibit may be amended from time to time upon mutual written agreement of the Parties.

EXECUTION

EXHIBIT B

SPECIFICATION AND REQUIREMENTS FOR LEO

LEO – Licensing Environment Online

SYSTEM MODULE	FUNCTIONS	LEO Avail	COMMENTS
Interface Entry	Login -Existing user	X	Create new subscribers – individual, business entity, company
	Login -New user	X	LEO will require some change to accept only one name.
Fee Payment Methods	Payment Options	X	Interfaces with Verisign.
	Choose License type and line of authority	X	
	Calculate State Fees	X	LEO captures a Line qualification fee. LEO also calculates fees for duplicate and temporary licenses
Enter Uniform Individual & Business Entity Resident & Non-Resident Application	Demographics	X	LEO does not require resident address, mailing address, citizenship.
	Affiliations	X	LEO may refer to this as Member List. Feature was unavailable to test in LEO
	Employment History		Not available in LEO
	Background Info		Not available in LEO
	Certification & Attestation		Not available in LEO
	Attachments		Not available in LEO
	Company Search	X	LEO provides company search based on company name, license and number. Able to retrieve dozens of companies in result set.

SYSTEM MODULE	FUNCTIONS	LEO Avail	COMMENTS
	Company Appointment	X	LEO requires that an appointment be assigned when applying for a license.
	ASI Details	X	LEO captures, Exam #, Exam date, Exam Center, Part-I Score, Part-II Score, School Code, Result. No active interface with ASI.
	Preparer's Information		Not available in LEO
	Data Validation/ Completeness Checks	X	Has required fields and performs data validations on specific fields.
	E-Mail	X	LEO sends an email to licensee when license application is submitted. The email contains a license number and URL to review the license.
Administrator	Change own Password	X	
	Subscription	X	
	Modify Profile (update demographics)	X	
	Manage Subscription	X	
Producer updates	My License(s)	X	
	Original Application	X	
	Duplicate License	X	
	Letter of Certification	X	
	Renewal Application	X	
	Producer Address	X	
	Line Addition	X	
	Line Deletion	X	

SYSTEM MODULE	FUNCTIONS	LEO Avail	COMMENTS
	Company Appointment	X	
	Company Termination	X	
	Member Appointment	X	
	Member Termination	X	
	Report Browser	X	
	Subscription Activity Report	X	
Companies		X	LEO allows states to maintain company related activities such as appointments.
Pre-licensing/		X	This module is undergoing quality assurance. Current schedule is to have module ready for production 9/30/2002. Will be provided to NAIC at no cost.
Continuing Education		X	LEO CE allows automated maintenance of CE related entities. Current schedule is to have module ready for production 9/30/2002. Will be provided to NAIC at no cost.
	Login	X	User id and password are required for LEO.
Original App	Entry	X	
	Audit	X	
	Approval	X	
Renewal App	Entry	X	
	Audit	X	
	Approval	X	
Lines/ Qualification	Addition	X	
	Addition Approval	X	

EXECUTION

SYSTEM MODULE	FUNCTIONS	LEO Avail	COMMENTS
	Deletion	X	
	Deletion Approval	X	
Company Appointment	Appointment	X	
	Termination	X	
Company Appointment Renewals	Appointment Renewals		Not available in LEO
Member	Appointment	X	
	Appointment Approval	X	
	Termination	X	
	Termination Approval	X	
Admin	Class/Lines	X	
	Class Line/Qualification	X	
	Class/Lines – Section/Line	X	
	Fee Maintenance	X	
	Partnership Type	X	
	Combining Records		Function not available in LEO
	Entity Deletion		Function not available in LEO
Duplicate License	Request	X	
	Approval	X	
Temporary License			Function not available in LEO
Blue Card		X	To be delivered at a later date.
Reports	Producer Licenses	X	
	Active Agent List	X	
	Captive Agent List	X	
	Daily License Issued	X	
	Total License Count	X	

SYSTEM MODULE	FUNCTIONS	LEO Avail	COMMENTS
	Other Reports		To be delivered at a later date.
FOIL	(Freedom of information Licensing)		Function not available in LEO
Administration	Receipt Details	X	
	Address Type	X	
	Country	X	
	State	X	
	County	X	
	Cash Sheet	X	
	PIN Interface		To be tested with NAIC
FEE	Fee Maintenance	X	
	Combination Type Linking	X	
	Combination Type	X	
Process Pending Licenses	View License Information	X	
	Demographic Data Update	X	LEO provides for update by external producer and state admin.
	Change License Status	X	
	Update checkboxes for pending reasons	X	LEO approval checks – Qualification checked, FPRC Checked, Fee Checked, and BlueCard Verified.
	Update Checkbox for Background Questions		Function not available in LEO
Workflow		X	
History/Audit Trail		X	LEO stores prior demographics and other historical licensing information on producers and companies in the system.
Search for a License/Agent		X	
Print License		X	

SYSTEM MODULE	FUNCTIONS	LEO Avail	COMMENTS
Notification	Notification via e-mail and/or letters	X	Part of Aithent's "go-back" technology. Current schedule is to have module ready for production 8/25/2002. Will be provided to NAIC at no cost.
Batch Print	Ability to print reports, licenses and letters in a batch job		Function not available in LEO. Aithent will show NAIC how reports can be created in LEO and then used to batch print information outside of LEO.
Help and User documentation			Sample documentation has been delivered to NAIC. To be delivered at a later date at no cost to the NAIC.
Complaints			Function not available in LEO
Browser		X	LEO runs only on Internet 5.5 and greater. It does not support Netscape.

EXECUTION

EXHIBIT C
NAIC AND AITHENT BAD DEBT AND REFUND POLICIES

NAIC

The following is the written policy of the NAIC and its affiliate, NIPR, with regards to the handling of bad debt and refunds:

It is the policy of the NAIC, and therefore the policy of its non-profit affiliate, NIPR, to pursue the collection of outstanding customer balances prior to them becoming aged to 60 days. Monthly statements of outstanding balances are sent to all customers. In the event a customer has not paid an invoice prior to it becoming 60 days or older, a more direct approach to customer payment is invoked.

Collection efforts on accounts of 60 days or more begin with correspondence and phone calls from the sales area. If these efforts fail the NAIC Credit and Collections Administrator, which was added as a full time accounts receivable management resource to the Accounting Department in 2001, takes on the task of collection. If these attempts for collection fail, though they rarely do, the account is turned over to the Legal Division who contacts the customer via written correspondence and demands payment. During this collection process, a cost/benefit assessment for the use of a collection agency is also performed. These processes have worked well for the NAIC and NIPR. Only after all of these efforts have failed does an account get written off.

Bad debt write-offs generally result from court orders, bankruptcy, liquidation, etc. When these documents are received the account is generally considered to be uncollectible and is written off but only after the proof-of-claim for the amount owed has been filed. These proofs-of-claim are monitored by the NAIC's Legal Division.

Refunds to NAIC/NIPR customers may result from (1) an erroneous invoice to the customer, (2) an overpayment of an invoice by the customer, or (3) billing system errors, data errors and/or system performance problems. Such refunds will be approved and processed by the NAIC/NIPR Manager with appropriate authorization level and the NAIC Accounting Department upon a review of the customer's request for refund and a determination that the customer should not pay for the services invoiced.

AITHENT

The following is the written policy of Aithent with regard to the handling of bad debt and refunds:

It is the policy of Aithent to pursue the collection of outstanding customer balances prior to them becoming aged to 60 days. Monthly statements of outstanding balances are sent to all customers. In the event a customer has not paid an invoice prior to it becoming 60 days or older, a more direct approach to customer payment is invoked.

Collection efforts on accounts of 60 days or more begin with correspondence and phone calls. If these efforts fail the Accounting Department takes on the task of collection. If these attempts for collection fail, the account is turned over to legal counsel, who contacts the customer via written correspondence and demands payment. During this collection process, a cost/benefit assessment for the use of a collection agency is also performed. Only after all of these efforts have failed does an account get written off.

Bad debt write-offs generally result from court orders, bankruptcy, liquidation, etc. When these documents are received the account is generally considered to be uncollectible and is written off but only after the proof-of-claim for the amount owed has been filed.

Refunds to Aithent customers may result from (1) an erroneous invoice to the customer, (2) an overpayment of an invoice by the customer, or (3) billing system errors, data errors and/or system performance problems. Such refunds will be approved and processed by the Aithent Manager with appropriate authorization level and upon a review of the customer's request for refund and a determination that the customer should not pay for the services invoiced.

EXECUTION

EXHIBIT D
STATE INSURANCE DEPARTMENTS

The following State Insurance Departments are processing electronic appointments and terminations utilizing a system other than LION prior to execution of this Agreement:

1. Alaska
2. Alabama
3. Arkansas
4. California
5. Connecticut
6. District of Columbia
7. Georgia
8. Hawaii
9. Idaho
10. Iowa
11. Kansas
12. Kentucky
13. Louisiana
14. Maryland
15. Michigan
16. Minnesota
17. Missouri
18. Montana
19. North Carolina
20. North Dakota
21. Nebraska
22. New Hampshire
23. New Jersey
24. New York
25. Nevada
26. Ohio
27. Oklahoma
28. Oregon
29. Pennsylvania
30. South Dakota
31. Tennessee
32. Texas
33. Utah
34. Virginia
35. Wisconsin
36. West Virginia
37. Wyoming

EXECUTION

EXHIBIT E
LION USERS

As of the effective date of this Agreement, the following State Insurance Departments are using LION:

1. New York
2. Arkansas

EXECUTION

EXHIBIT F
FORMAT FOR ROYALTY PAYMENT STATEMENTS

NAIC/AITHENT Licensing Agreement
Royalty Payment Statement
For the Period Ended:

State	License Fee Collected (1)	Transaction Fee Collected (2)	Transaction Type	Net Revenue Collected During Period	Royalty Amount
(A)	(B)	(C)	(D)	(B) + (C)	XX
			Subtotal		XX
			Less:		
			Fee Refunds (1)		XX
			Total SBS Royalty Payment Enclosed		XX

Notes:
(1) A detailed spreadsheet will be attached to reconcile the amounts summarized above, listing license fees by state and date collected and refunds by customer and date paid.
(2) Each line of this summary spreadsheet will be supported by a Detail Report of Electronic SBS Transactions Per State as illustrated below.

NAIC/AITHENT Licensing Agreement
Detail Report of Electronic SBS Transactions Per State
For the Period Ended:

Transaction Type: BB
Implementation Date of Transaction:
Note: Royalties on this transaction are payable to NAIC/Aithent through ________________.

Invoice #	State	Transaction Date	Payment Type	Transaction Fee Collected	Date Collected	Customer ID#
(E)	(A)	XX/XX/XX	Credit Card	(C)	XX/XX/XX	(F)

Questions for the Record – Subcommittee on Housing and Insurance
Date: Tuesday, February 4, 2014
Name: "The Federal Insurance Office's Report on Modernizing Insurance Regulation"

Congresswoman Kyrsten Sinema for Commissioner Leonardi and Director McRaith

Question 1:

The MyRA retirement account, according to the U.S. Treasury, is "designed to help savers start on a path to long-term saving and serve as a stepping stone to the broader array of retirement products available in today's marketplace." How does Treasury plan to transition workers to take that next step? What tools will Treasury provide workers to ensure that their MyRA account is a true starting point to retirement security?

Answer:

*my*RA will allow working Americans who do not have access to a retirement savings option through their employer to begin to build a nest egg for retirement by getting individuals in the habit of saving. Through payroll deduction, savers have a simple, safe, and affordable way to put away $5 or more per pay check into their *my*RA account, which will never go down in nominal value. Additionally, savers will be provided with information about private-sector Roth IRA options when their account nears the maximum threshold of $15,000 or 30 years, whichever comes first. To that end, Treasury will be issuing a Request for Information (RFI) to solicit ideas about the process for transferring *my*RA savers into private-sector retirement options once they have reached that threshold and the security has stopped earning interest.

Question 2:

If the goal is to have the best prudential supervision, the most effective regulation of the financial services industry, does it make sense to apply bank capital standards to insurance companies? If a bank-centric capital standard is misapplied to insurers, what is the impact on the average family in Arizona insuring their financial security with a life insurance policy or annuity?

Answer:

Banks and insurance companies should be regulated based on their unique business models. To that end, when it released the final rules implementing Basel III standards last summer, the Federal Reserve indicated its intention to study carefully the appropriate application of capital standards to companies with significant insurance operations.

The Federal Reserve is also responsible for promulgating the enhanced prudential standards that will be applicable to nonbank financial companies designated by the Financial Stability Oversight Council and therefore subject to supervision by the Federal Reserve. Section 165 of the Dodd-Frank Act authorizes the Federal Reserve to differentiate among companies, taking

into consideration insurers' financial activities and other factors, in prescribing these prudential standards. The Federal Reserve has indicated that it intends to use this discretionary authority when developing prudential standards that will be applicable to insurers and other nonbank financial companies. The Federal Reserve also has consulted with the Financial Stability Oversight Council and the Federal Insurance Office during the development of its enhanced prudential standards, and I would expect the interagency dialogue to continue during this process.

Question 3:

If the Federal Reserve proposes a bank capital standard for insurance companies under its supervision, while the Arizona Department of Insurance enforces an insurance standard, what would be the implications for insurance companies in Arizona? Could we have a situation where two regulators are trying to enforce two different, incompatible standards on the same company?

Answer:

State regulation, which directly regulates only insurance entities, requires those insurance entities to satisfy risk-based capital and minimum capital requirements. Separately, Section 171 of the Dodd-Frank Act requires the federal banking agencies to establish leverage and risk-based capital requirements applicable to insured depository institutions (IDIs), depository institution holding companies, and nonbank financial companies designated by the Financial Stability Oversight Council. Therefore, these capital standards would apply on a consolidated level to insurance companies that are savings and loan holding companies and to those that are designated by the Council. These standards should be compatible and reflect the business model of insurance.

Question 4:

The IRS is about to issue supplemental regulations to implement FATCA. As the regulations are currently written, non-cash value insurance would be susceptible to the FACTA regime, putting burdensome compliance on companies that place non-cash value insurance policies, which simply cannot be used for tax evasion and have nothing to do with FATCA's intent. Are you aware of this issue, and have you worked on this with staff at IRS?

Answer:

The Treasury Department has had many discussions with stakeholders and with the IRS about the appropriate application of the FATCA rules to non-cash value insurance contracts and companies that issue them. Additionally, the drafters of the rules in Treasury's Office of Tax Policy have consulted with insurance experts from the Federal Insurance Office. FATCA is a key part of the U.S. government's multi-pronged effort to combat the use of offshore accounts

and foreign entities to evade U.S. income tax. When considering how FATCA should apply to non-cash value insurance, it is important to distinguish the risk of tax evasion associated with financial accounts held by U.S. persons at foreign financial institutions from the risk of tax evasion associated with certain non-financial foreign entities that have substantial U.S. owners.

With respect to tax evasion associated with offshore financial accounts, the Treasury Department and the IRS believe that non-cash value insurance contracts present a low risk of being used for tax evasion purposes. Accordingly, the final FATCA regulations issued in 2013 ("2013 regulations") provide that non-cash value insurance contracts are not treated as financial accounts, with the result that insurance companies are not required to report on the beneficial owners of these contracts. Moreover, a foreign insurance company that only issues non-cash value insurance contracts is not treated as a foreign financial institution under FATCA.

If a foreign insurance company is privately held, however, it may be treated as a non-financial foreign entity that is required to provide information about its substantial U.S. owners, if any, to withholding agents in order to avoid FATCA withholding on withholdable payments made to it. The 2013 regulations do not exempt privately held insurance companies from this requirement because the Treasury Department and the IRS are aware that some closely-held foreign insurance companies that issue only non-cash value insurance contracts are being used by their U.S. owners to invest in foreign assets and avoid reporting to the IRS the income earned on these assets. Information about the substantial U.S. owners of such entities is a key element of U.S. enforcement efforts against these tax avoidance structures. To ensure that this information will be reported to the IRS, the FATCA regulations do not exempt U.S. source premiums paid with respect to non-cash value insurance from treatment as a withholdable payment. The FATCA regulations that were issued in March 2014 do not change the treatment of non-cash value insurance contracts, or of privately held foreign insurance companies.

The Treasury Department and the IRS will continue to engage with stakeholders to implement FATCA in a manner that appropriately balances the compliance objectives of the statute with the burdens imposed.